

THE ELECTIVE LARGE PARTNERSHIP RULES[©]

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THE ELECTIVE LARGE PARTNERSHIP RULES*

I. INTRODUCTION

A new elective regime was created for large partnerships as part of the Taxpayer Relief Act of 1997 (the “1997 Act”). The new rules dramatically alter the tax treatment of large partnerships that elect to be taxed under the new regime (such partnerships, “ELPs”). The provisions added in Sections¹ 771 through 777 govern the pass-through treatment and reporting requirements of ELPs (the “Reporting Rules”). Sections 6240 through 6255 govern audit procedures and other administrative matters of ELPs (the “Audit Rules”). The ELP Reporting and Audit Rules (together, the “Elective Large Partnership Rules,” or the “ELP Rules”) apply with respect to partnership tax years beginning after December 31, 1997.²

The genesis of the Elective Large Partnership Rules was Section 10126 of the Tax Simplification Bill of 1987, which first addressed the tax treatment of large partnerships. Although no large partnership provisions were enacted in 1987, the 1987 Tax Act directed the Internal Revenue Service (“IRS”) and the Treasury Department (“Treasury”) to prepare a joint report on the compliance and administrative issues posed by large partnerships (the “Treasury Report”).

The Treasury Report, which was delivered to the House Ways and Means Committee in March 1990, included a lengthy discussion of the administrative burdens that large partnerships impose on the IRS and Treasury as a result of the audit rules enacted in 1982 (the “TEFRA Rules”).³ Individual partners

* Thanks and kudos go to Michael E. O’Brien for his substantial contributions to this article, and to Michael Antovski for updating the article.

¹ All references to Sections are to Sections of the Internal Revenue Code of 1986, as amended.

² Pub. L. No. 105-34, §§ 1221 - 1222, 111 Stat. 788, 1001-1019.

³ These administrative burdens include: (i) the complexity involved in negotiating settlements with individual partners, who are each

holding small interests in large partnerships also complained and were dissatisfied with the complexity of the partnership reporting rules. These partners, who viewed their partnership interests in the same manner as their investments in corporate stock and mutual funds, were receiving Schedule K-1s from the partnerships sometimes listing as many as 40 separate items of income, gain, loss, deduction and credit.⁴ In response to these criticisms and those outlined in the Treasury Report, the House of Representatives proposed statutory rules governing the pass-through treatment, reporting requirements, audit procedures and other administrative matters of large partnerships in 1994 (the “1994 Proposed Rules”).⁵ As the Senate did not act on the 1994 House tax bill, the 1994 Proposed Rules were not enacted into law.

Congress finally enacted the Elective Large Partnership Rules as part of the 1997 Act. Although the 1994 Proposed Rules provide the framework for the new rules, perhaps in response to concerns posed by commentators,⁶ the ELP Rules enacted an elective regime rather than the mandatory tax regime initially proposed for large partnerships.⁷

entitled to participate in audits and other IRS proceedings concerning partnership items, (ii) administering refund claims separately filed by those partners, (iii) the IRS’ difficulty in locating former partners and collecting deficiencies from those partners and (iv) the inability of the IRS to detect undisclosed, inconsistent reporting by partners and the resulting significant revenue loss to the fisc.

⁴ S. Rep. No. 33, 105th Cong., 1st Sess. 238 (1997) (the “1997 Senate Report”).

⁵ H.R. 3419, 103d Cong., 1st Sess. (1994).

⁶ *See, e.g.*, New York State Bar Association Tax Section, *Report on the Large Partnership Provisions of the Tax Simplification Bill*, *Tax Notes Today*, Dec. 22, 1994, LEXIS, 94 TNT 250-22; *NYSBA Tax Section Objects to “Current Partner Liability Rule” in Proposed Legislation*, *Tax Notes Today*, Oct. 4, 1995, LEXIS, 95 TNT 194-21.

⁷ The 1994 Proposed Rules would have mandatorily imposed a new tax regime on all partnerships with over 250 partners, and would have allowed partnerships with over 100 partners to elect such large partnership treatment. H.R. 3419, § 301(a) (proposed I.R.C. § 775(a)).

The Elective Large Partnership Rules depart significantly from the historical pass-through tax treatment of partnerships, and also from the TEFRA Rules. As a result, partnerships that qualify to elect application of the ELP Rules (such election, an “ELP Election”) should carefully consider whether, and under what circumstances, they would actually benefit from choosing to be subject to the ELP Rules.

II. PARTNERSHIPS QUALIFYING TO ELECT ELP STATUS

A. Eligible Partnerships

A partnership generally qualifies to make an ELP Election if it had 100 or more partners in the partnership’s preceding taxable year, and will be subject to the ELP Rules if it affirmatively elects on its tax return to do so.⁸ Qualification is determined by reference to direct partners, so that a partnership desiring to elect ELP status cannot look to partners of upper-tier partnerships to increase its number of partners.⁹ Any eligible partnership that makes an ELP Election will be subject to the ELP Rules for that taxable year and all subsequent tax years. The ELP Election cannot be revoked without the Treasury Secretary’s consent.¹⁰ To the extent provided in regulations, a partnership will

⁸ I.R.C. § 775(a)(1). Basing the determination of “number of partners” on the preceding partnership taxable year differs from the test employed by the 1994 Proposed Rules, which would have based the calculation on the partnership’s current tax year. *See* H.R. 3419, § 301(a) (proposed I.R.C. § 775(a)(1)). The IRS has in at least one case been relatively lenient with a partnership that did not meet all the technical filing requirements for an ELP Election. *See* PLR 200221020 (May 24, 2002) (holding that a partnership that attempted to make a Section 775 election, but used the wrong form, would be considered to have made the election because it had substantially complied with the election requirements, but conditioning the holding on the partnership subsequently filing the appropriate form).

⁹ 1997 Senate Report at 243.

¹⁰ I.R.C. § 775(a)(2).

cease to be treated as an ELP if it has fewer than 100 partners in any taxable year.¹¹

B. Excluded Partnerships

Certain types of large partnerships are not eligible to make an ELP Election. For example, partnerships principally engaged in the commodities business are excluded from the ELP Rules.¹² Moreover, an otherwise eligible partnership may not make an ELP Election if substantially all of its partners (or the owner-employees of its personal service corporation partners) (i) perform substantial services in connection with the partnership's activities, (ii) performed such substantial services prior to retirement or (iii) are spouses of partners who are performing (or have previously performed) such substantial services.¹³ However, partnership interests held by children, grandchildren, and trusts for the benefit of children and grandchildren are not treated as held by such service providers for purposes of the "substantially all" test. The activities of a service partnership include the activities of lower-tier partnerships in which it owns a direct interest of at least 80% of the capital and profits.¹⁴ In effect, for purposes of the 100-partner test, individuals holding partnership interests and performing substantial services in connection with the partnership's activities, and individuals who previously performed substantial services while holding a partnership interest, are not considered partners.¹⁵

As discussed above, a partnership cannot qualify to make an ELP Election if "substantially all" of its partners (or spouses) either currently perform or have performed services for the partnership. However, the parameters of the "substantially all" test for service partnerships are not clear—the ELP Rules do not

¹¹ I.R.C. § 775(a). Moreover, pursuant to Section 777, the Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of the Reporting Rules. As of February 28, 2003, the IRS has not issued any such regulations.

¹² I.R.C. § 775(c).

¹³ I.R.C. § 775(b)(2).

¹⁴ I.R.C. § 775(b)(3).

¹⁵ I.R.C. § 775(b)(1).

provide any explanation of how “substantially all” is to be determined. In the absence of guidance, a sensible rule of thumb may be the New York State Bar Association’s view that “substantially all” means 90% of the partnership’s profits and capital interests.¹⁶

The IRS may treat a nonqualifying partnership that makes an ELP Election on its partnership return as an ELP in all subsequent years, even if the partnership was not actually eligible to elect ELP treatment. While such an invalid election may bind the partnership, it will not, of course, bind the IRS.¹⁷

III. SCOPE OF THE ELP RULES AND TREASURY AUTHORITY TO PROMULGATE REGULATIONS

Regulations are to be promulgated to make appropriate adjustments to the ELP Rules to take into account partnership adjustments that involve a change in the character of any item of income, gain, loss or deduction.¹⁸ More generally, the Secretary is also granted the authority to prescribe “such regulations as may be appropriate to carry out the purposes” of the ELP Rules.¹⁹ The legislative history accompanying the 1997 Act provides that these regulations may include rules governing partnership interest transfers to tax-favored persons or entities in anticipation of adjustments, *e.g.*, to corporations with net operating losses, tax-exempt organizations, shell corporations and foreign persons. The regulations may provide, among other things, that partnership adjustments are treated as taking effect before a transfer was completed, or that the former partner is treated as a current partner for purposes of the ELP Rules. Where partnership interests are transferred to foreign persons, the regulations may provide that

¹⁶ See New York State Bar Association Tax Section, *Report on the Large Partnership Provisions of the Tax Simplification Bill*, *Tax Notes Today*, Dec. 22, 1994, LEXIS, 94 TNT 250-22.

¹⁷ I.R.C. § 775(d).

¹⁸ I.R.C. § 6242(d)(5).

¹⁹ I.R.C. §§ 777, 6255(g).

partnership adjustments are treated as effectively connected income.²⁰

IV. SIMPLIFIED REPORTING AND FLOW-THROUGH TREATMENT OF PARTNERSHIP ITEMS OF ELPs

A. Separately Stated Items

Partners in ELPs take into account only eleven items on a flow-through basis, which significantly limits the items an ELP must separately report to its partners. These flow-through items are: (1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities; (3) net capital gain or loss, separately computed to the extent allocable to passive loss limitation activities and other activities; (4) tax-exempt interest; (5) net alternative minimum tax adjustment, separately computed for passive loss limitation activities and other activities; (6) general credits; (7) low-income housing credits; (8) rehabilitation credits; (9) foreign income taxes; (10) credit for producing fuel from a nonconventional source; and (11) dividends received that constitute qualified dividend income.²¹ The IRS also has the authority to specify additional items that must be separately reported.²² Income or loss from passive loss limitation activities is defined as income or loss from any activity involving the conduct of a trade or business, or any rental activity.²³ Income or loss from “other activities” is always treated as investment income or loss.²⁴ As is generally the case with partnerships, the ELP partner’s characterization of separately reported items is generally determined as if realized or incurred directly from the same source as the partnership.²⁵

²⁰ 1997 Senate Report at 249.

²¹ I.R.C. § 772(a); Notice 2004-5, 2004-7 I.R.B. (Feb. 17, 2004).

²² I.R.C. § 772(a)(11).

²³ I.R.C. § 772(d)(1). The term “trade or business” includes research and experimentation activity.

²⁴ I.R.C. § 772(c)(3)(A).

²⁵ I.R.C. § 772(c)(1); *see* I.R.C. § 702(b).

B. Computation of ELP Income and Loss

An ELP computes its income and loss in the same manner as an individual, except that flow-through items are separately stated.²⁶ Limitations and elections affecting the taxable income or any tax credit of an ELP (including, for example, Section 1231 calculations) are generally applied or made at the partnership level.²⁷ Certain additional modifications are then made to the calculation of the ELP's taxable income.²⁸ An ELP is not permitted deductions for personal exemptions, net operating loss deductions, and the additional itemized deductions for individuals provided in part VII of subchapter B of the Code (other than Section 212 expenses incurred for the production of income).²⁹ Charitable deductions are generally limited to 10% of the partnership's taxable income.³⁰ Miscellaneous itemized deductions, such as Section 212 expenses incurred for the production of income, are subject to a 70% disallowance at the ELP level, which is intended to approximate the deductions that would be denied to an individual partner under the Section 67(a) 2% floor.³¹ As a result, the 30% deduction allowed at the partnership level is not subject to the 2% floor at the partner level.³² The at-risk, passive loss and Section 68 overall itemized deduction limitations are each applied at the partner level.³³

The ELP Rules net capital gains and losses at the partnership level, and any excess of partnership net short-term capital gain over net long-term capital loss is consolidated with the partnership's ordinary income and is not separately reported to

²⁶ I.R.C. § 773(a)(1)(A).

²⁷ I.R.C. §§ 773(a)(2), (3).

²⁸ Under Section 776, special rules apply to partnerships holding oil and gas properties. A discussion of those rules is beyond the scope of this article.

²⁹ I.R.C. § 773(b)(1).

³⁰ I.R.C. § 773(b)(2); *see* I.R.C. § 170(b)(2).

³¹ I.R.C. § 773(b)(3); 1997 Senate Report at 240.

³² I.R.C. § 772(c)(3)(B).

³³ I.R.C. § 773(a)(3)(B). Regulations may provide that other limitations be applied at the partner level. I.R.C. § 773(a)(3)(B)(iv).

partners.³⁴ By contrast, outside of the ELP regime, a partner's share of a partnership's net short-term capital gain or loss and its net long-term capital gain or loss are separately reported to each partner.³⁵ A partner's allocable share of an ELP's resulting net capital gain or loss is treated as long-term capital gain or loss.³⁶ Such net capital gain or loss is allocated first to passive loss limitation activities to the extent of net capital gain or loss from the sale or exchange of property used in connection with such passive loss limitation activities, and any excess net capital gain or loss is then allocated to other activities.³⁷

Any limited partner's distributive share of the ELP's (i) taxable income or loss from passive loss limitation activities, (ii) net capital gain allocable to passive loss limitation activities and (iii) net alternative minimum tax adjustment separately computed for passive loss limitation activities is treated as derived from the conduct of a single passive activity.³⁸ However, with respect to a general partner's interest in an ELP, the ELP must account for amounts from each passive loss limitation activity in order for the general partner to comply with the passive activity loss rules in Section 469.³⁹

The installment sale rules of Section 453(l)(3) (timeshares and residential lots) and Section 453A (nondealers) are applied at the ELP level, and in determining the interest payable under those sections, the partnership is treated as being subject to the highest rate of tax in effect for either individuals or corporations.⁴⁰

Any tax credit recapture is also determined at the partnership level, and the amount of such recapture is determined

³⁴ I.R.C. § 772(a)(3); 1997 Senate Report at 240.

³⁵ I.R.C. § 702(a).

³⁶ I.R.C. § 772(c)(4).

³⁷ I.R.C. §§ 772(d)(4)(B), (C).

³⁸ I.R.C. § 772(c)(2).

³⁹ I.R.C. § 772(f).

⁴⁰ I.R.C. § 774(f).

as if the credit had been fully utilized to reduce tax.⁴¹ The recaptured credit reduces the amount of the current year credit, and the partnership is liable for any excess recapture amount.⁴² No credit recapture is required by reason of any transfer of an ELP interest.⁴³

The election to claim foreign tax credits will continue to be made at the partner level.⁴⁴ ELP income from the discharge of indebtedness is also reported separately to its partners,⁴⁵ and the applicability of the Section 108 rules will continue to be determined at the partner level.⁴⁶

The distributive share reported to any organization subject to the Section 512 unrelated business tax (“UBT”) must be reported separately to the extent necessary in order for that partner to comply with the UBT requirements.⁴⁷

An ELP partner’s distributive share of any separately reported amount must take into account any adjustment required under Section 743(b) with respect to that partner.⁴⁸

C. Detrimental Effects of the Simplified Flow-Through Rules

The simplified flow-through treatment will likely deny benefits to certain partners because of the failure to state certain items of income and deduction. Before electing ELP status, a partnership should consider the potentially detrimental effect of this quasi-entity-level tax treatment the ELP Rules impose on partners, in particular in the case of partnerships with both corporate and individual partners.

⁴¹ I.R.C. § 774(b)(1).

⁴² I.R.C. § 774(b)(2).

⁴³ I.R.C. § 774(b)(3).

⁴⁴ I.R.C. § 773(a)(2).

⁴⁵ I.R.C. § 773(c)(2)(A).

⁴⁶ I.R.C. § 773(a)(2).

⁴⁷ I.R.C. § 772(e).

⁴⁸ I.R.C. § 774(a)(2).

1. Investment Deduction Limits

The ELP Rules disallow 70% of partners' deductions for ELP expenses that would be treated as miscellaneous itemized deductions in the hands of an individual.⁴⁹ This rule may approximate the portion of deductions allowed for some or many individuals, but it represents a 70% reduction of such deductions that are otherwise fully available to corporate partners. Consequently, corporations may be reluctant to invest in ELPs that have high expenses, since 70% of these deductions is not passed through to them. By contrast, Section 7704 permits publicly traded investment partnerships with corporate partners to be taxed as partnerships with separately stated expense deductions. Similarly, dividend income received by ELPs is not reported to the partners as a separately stated item of partnership income. The ELP Rules consequently deny corporate partners the ability to claim otherwise available dividends-received deductions by including dividend income in the definition of taxable income or loss from "other activities."

2. Net Short-Term Capital Gain Elimination

An ELP's net short-term capital gain in excess of its net long-term capital loss is combined with the ELP's income from other activities at the entity level. Since such short-term capital gain is not separately stated, partners cannot use other capital losses to offset that capital gain. Individual partners with capital loss carryovers may find this result particularly unappealing.

3. Charitable Contribution Limits

Outside the ELP regime, charitable deductions are separately reported to partners.⁵⁰ Under the ELP Rules, however, charitable contributions are calculated at the partnership level and are subject to the limit for corporations under Section 170(b)(2) (generally 10% of taxable income).⁵¹ If a partner's individual or corporate taxable income is relatively high, and the partnership itself has little taxable income, one or more individual partners of

⁴⁹ I.R.C. § 773(b)(3).

⁵⁰ I.R.C. § 702(a)(4).

⁵¹ I.R.C. § 773(b)(2).

an ELP may be denied charitable contribution deductions that they could otherwise utilize if such contributions were separately reported.⁵²

V. CONSISTENT REPORTING REQUIREMENT FOR ELP PARTNERS

Under the ELP Rules, a partner may not report a partnership item inconsistently with the manner in which the item is reported on the ELP's tax return.⁵³ Any underpayment attributable to an inconsistently reported partnership item will be immediately assessed and collected as if it were a mathematical or clerical error on the partner's return.⁵⁴ By contrast, outside the ELP regime, a partner may report its partnership items inconsistently with the partnership's position as long as the inconsistency of the positions is disclosed on the partner's tax return.⁵⁵

Requiring partners to report partnership items consistently with the partnership's treatment of those items may require partners to sign a tax return that they believe contains incorrect information. The ELP Rules provide such partners with a modicum of protection, since partners in ELPs are not personally liable for interest and penalties occasioned by the incorrect reporting of partnership items to partners, as discussed below.⁵⁶

VI. ELP AUDIT ADJUSTMENT LIABILITY

A. Current Year Liability

The ELP Rules generally treat adjustments to partnership items of income or loss ("Partnership Adjustments") as giving rise to additional ELP taxable income or loss for the year the

⁵² Section 170(b)(1)(A) generally limits individuals' charitable contributions to 50% of adjusted gross income.

⁵³ I.R.C. § 6241(a).

⁵⁴ I.R.C. § 6241(b).

⁵⁵ I.R.C. § 6222(b).

⁵⁶ I.R.C. § 6242(b).

adjustments take effect, which income or loss flows through to the ELP partners in that year, rather than to the partners for the prior year to which the Partnership Adjustments relate.⁵⁷ As discussed below, the ELP, rather than current (or former) partners, is liable for any interest and penalties imposed in connection with Partnership Adjustments.⁵⁸

If an ELP ceases to exist before an adjustment takes effect, the former partners of the ELP are required to take Partnership Adjustments into account. Forthcoming regulations will define “former partners” and will provide rules governing the collection of tax liabilities resulting from Partnership Adjustments (“Partnership Assessments”) from former partners.⁵⁹

1. Current Partner Liability

A current partner’s share of ELP income and loss items will be adjusted to reflect Partnership Adjustments that take effect in the current year, regardless of whether the partner was a partner during the taxable year or years under audit. Each current partner’s tax liability attributable to the adjustments will depend on that partner’s marginal tax rate. Partnership Adjustments relating to an audit adjustment that are attributable to taxable years subsequent to the year under audit (but prior to the current year) will be taken into account in the current year and will be netted against the primary audit adjustment to determine the amount of a Partnership Adjustment.⁶⁰

2. ELP Imputed Underpayments

In lieu of having its current partners personally bear the tax liability resulting from a Partnership Assessment, an ELP generally may elect to pay an “imputed underpayment.”⁶¹ The imputed

⁵⁷ I.R.C. § 6242(a)(1).

⁵⁸ I.R.C. § 6242(b).

⁵⁹ I.R.C. § 6255(d).

⁶⁰ I.R.C. § 6242(a)(3).

⁶¹ I.R.C. §§ 6242(a)(2)(A), (b)(4). The partnership will be deemed to have made the “imputed underpayment” election if the partnership does not make such an election but fails to fully take into account

underpayment is calculated by multiplying the Partnership Adjustments by the highest individual or corporate tax rate in effect for the partnership taxable year to which the Partnership Adjustments relate.⁶² A partner may not file a credit or refund claim for its share of the partnership's imputed underpayment, even if the partner's marginal tax rate is less than the tax rate used to compute the imputed underpayment.⁶³ An ELP may make an election to pay the imputed underpayment only if it meets certain requirements, which will be set forth in future regulations, designed to ensure payment.⁶⁴

An ELP's decision as to whether to satisfy a Partnership Assessment at the entity level may be quite complex. Since an ELP pays tax on a Partnership Adjustment at one rate (the highest rate for the years being adjusted), while each partner would pay tax at its own current-year rate, an ELP entity-level payment election might produce suits from disgruntled partners with lower tax rates than the rate at which the ELP is subject to tax. As a result, ELP managers may frequently be placed in an untenable situation.⁶⁵ Moreover, even an ELP announcement of its intention to pay deficiencies may provide little comfort to partners insisting on limited liability, because they will nonetheless be required to pay if the ELP has no liquid funds when the tax is due. Not surprisingly,

any Partnership Adjustment as required by Section 6242(a)(1), or if the adjustment involves a reduction in a credit which exceeds the amount of such credit for the year in which the adjustment takes effect. I.R.C. §§ 6242(a)(2)(B), (C).

⁶² I.R.C. §§ 6242(b)(4), (d)(3). The imputed underpayment must be paid by the return due date for the partnership's taxable year in which the adjustment takes effect. I.R.C. § 6242(c)(1)(B). If the ELP fails to pay the amount by the required time, a penalty of 10% of the imputed underpayment amount is assessed to the ELP. I.R.C. § 6242(c)(3)(A).

⁶³ 1997 Senate Report at 247.

⁶⁴ 1997 Senate Report at 247. The legislative history references the case of a foreign partnership as an example where it may be difficult to ensure payment.

⁶⁵ It would be prudent for the partners to determine whether their partnership agreement should address whether the ELP will elect payment at the partnership level, and, if so, under what circumstances.

any election as to who satisfies a Partnership Assessment, and at what rate, gives rise to tax-planning possibilities, particularly if rates differ between the audit year(s) and the current year.⁶⁶

If an ELP elects to satisfy a Partnership Assessment, rather than pass the liability through to its current partners, the tax is calculated by multiplying the adjustment by the highest personal or corporate tax rate in effect for the year to which the item being adjusted relates. As a result, the tax paid by the ELP may be imposed at rates that exceed each partner's actual tax rates. Because the ELP is not treated as merely the paying agent for the tax, there is no opportunity for each partner to claim a refund if the partner's allocable share of the tax paid by the partnership would exceed the partner's actual tax liability for its allocable share of the same adjustment.⁶⁷

3. Former Partner Liability

There is one exception to the liability of current-year partners for Partnership Assessments (in the absence of a partnership-imputed underpayment). Former partners whose distributive shares of income or loss are reallocated in connection with Partnership Adjustments will remain personally liable for any assessment of tax attributable to such reallocation, and the ELP and its current partners will have no liability for these Partnership Assessments.⁶⁸ The statute of limitations for assessing any underpayment of tax or filing a claim for credit or refund of any overpayment of tax attributable to such adjustments is the same as

⁶⁶ It is worth noting that since the election under Section 6242(a)(2)(A) is not binding on a going-forward basis, ELPs may separately elect with respect to each Partnership Assessment whether the ELP or its partners will bear the liability.

⁶⁷ By contrast, this type of credit system currently exists with respect to withholding under Section 1446, whereby foreign partners may request refunds of tax withheld on income from U.S. partnerships engaged in a U.S. trade or business if the amount of tax withheld exceeds the foreign partner's actual U.S. federal income tax liability with respect to the income.

⁶⁸ I.R.C. § 6241(c)(2).

that for making adjustments to the partnership itself under Section 6248.⁶⁹

This special rule concerning distributive share reallocations is sensible, but it also illustrates the complexity of imposing certain tax liabilities on the current partners of an ELP while imposing other liabilities (directly or indirectly) on the former partners. For example, an audit may involve both allocation and other issues, with the result that different adjustments may be made to two groups of partners with respect to the same audit of a single taxable year. Thus, a partner in both the prior year under audit and the current year may have one adjustment for the prior year and another adjustment for the current year. Moreover, there is no apparent right of offset between the two adjustments, even though they in fact both arose in a single taxable year of the partnership. This division may create cash flow problems for partners.

4. Liability for Interest and Penalties

The ELP Rules treat interest and penalties stemming from Partnership Adjustments as liabilities of the ELP itself.⁷⁰ Interest is calculated on the Partnership Adjustments for the period beginning on the return due date for the adjusted year and ending on the earlier of the return due date for the partnership taxable year in which the adjustment takes effect or the date the partnership pays the imputed underpayment.⁷¹ Penalties are determined on a year-by-year basis without offsets on the basis of an imputed underpayment amount (regardless of whether the partnership actually elected to assume tax liability at the partnership level by paying the imputed underpayment). All accuracy penalty and waiver criteria (*e.g.*, reasonable cause, substantial authority) are determined, and penalties are assessed and interest with respect to penalties accrues, as if the ELP were a taxable individual.⁷²

Liability is fairly imposed on ELPs for interest and penalties attributable to adjustments of partnership items

⁶⁹ I.R.C. § 6241(c)(2)(C).

⁷⁰ I.R.C. § 6242(b).

⁷¹ I.R.C. § 6242(b)(2).

⁷² I.R.C. § 6242(b)(3); 1997 Senate Report at 248.

incorrectly reported to partners in light of the consistent reporting obligations imposed by the ELP Rules. It would be particularly inequitable to assess interest and penalties attributable to partnership adjustments directly against current partners when the assessment is attributable to items reported in a prior year in which a current partner may not have been a partner. The current partners had no benefit of an interim use of funds (and so should not pay interest) and they had no intent to avoid taxes when filing a prior return (and so should not pay penalties). It bears noting, however, that even if the ELP itself pays the interest and penalties, the current partners are still indirectly penalized, since they indirectly bear such amounts through the reduction in value of their ELP interests. However, at least current partners are not burdened with personal liability for such amounts (assuming the ELP has assets sufficient to satisfy such liabilities); their liability is limited to the value of their ELP interests.

Former partners who remain liable for tax also benefit from the ELP's paying the related interest on such adjustments. Former partners who remain liable for tax would also benefit if and to the extent the ELP is saddled with penalties for reporting positions that were within their control (*i.e.*, adjustments that do not depend on the manner in which items are reported to the partners, such as adjustments attributable to individual partners' at-risk or passive loss limitations).

Since most large partnerships do not currently have significant cash reserves, ELPs may be forced to sell assets under inopportune conditions to raise funds to satisfy interest and penalties assessed against the ELP. In order to prevent this result, ELPs should consider reserving funds for the payment of interest and penalties resulting from Partnership Assessments.

B. The Tax Consequences of Current Year Liability

Outside the ELP regime, partners retain liability for taxes attributable to partnership operations for prior years after transfers of their partnerships interests. The ELP Rules represent a fundamental change to the basic tenet of partnership taxation, that a partner is subject to, and retains liability for, tax on current income of the partnership.

1. Commercial Issues

The ELP Rules concerning liability create new and complex issues, whether an ELP or its current partners satisfy a Partnership Assessment. In particular, complexities are created by the need to allocate Partnership Adjustments among the current partners to determine basis, book capital accounts, and tax capital accounts, and the possible need to apply Section 704(c) principles to reduce resulting differences between book and tax capital accounts.

The ELP Rules may have a significant effect on trading in ELP interests. For example, news of a tax audit could significantly depress the trading price of such partnership interests, since current partners might be required to bear the tax burden of many years of misreporting by the partnership and former partners. Moreover, since current partners are responsible for satisfying any tax liability, and since the exact date (or, at least, year) of the resolution of the audit will determine which partners will bear the tax cost of the resolution,⁷³ there will be a premium on advance knowledge by partners as to the expected settlement date. Many partners may sell their partnership interests prior to a large expected settlement, and the market value of the interests may fluctuate on the basis of speculation about the timing of a significant settlement. Moreover, any partner making a significant investment in an ELP will need to conduct “due diligence” of the partnership’s past tax reporting positions to determine whether there is a hidden contingent liability, and well-advised partners may wish to seek protection from liability by obtaining an indemnity from the selling partner.

If an ELP requires its current partners to pay the tax on any Partnership Adjustments, future investments by limited partners in ELP may be significantly chilled. The fundamental economic assumption of an investor in a limited partnership (or limited

⁷³ The ELP Rules do not make clear whether a Partnership Adjustment will apply to partners who were partners on the actual date that the audit is resolved, or to all partners who were partners at any time during the year. In the absence of guidance, the income resulting from an adjustment will presumably be treated as any other partnership income arising on the adjustment date and will be allocated under the normal rules of the partnership agreement.

liability company), that although the investor will be liable for current taxes on current partnership income, the investor will not be liable for other debts of the partnership, and will have only its partnership interest at the risk of the business, will be undermined. This is one of the key attractions of a limited partnership investment. Imposing liability on limited partners for past misreporting by the partnership is fundamentally inconsistent with this assumption.

Limited partners are likely to take little comfort from the basis increase that accompanies a Partnership Adjustment, since that increase will, at best, provide them with a capital loss benefit some years in the future.⁷⁴ In fact, the ELP Rules place a limited partner in a worse position than a purchaser of stock in a corporation, because a stock purchaser is not personally liable for debts of the corporation.

2. Arbitrage Opportunities

The ELP Rules create considerable tax-planning possibilities because of the discontinuity between the former partners who failed to pay sufficient tax on the ELP's "real" income and the current partners who are liable to pay the tax. This discontinuity arises because the adjustments to prior-year income are reflected in income taxed at the partner level at current-year rates.⁷⁵ For example, there would be a considerable incentive to transfer ELP interests from high-bracket to low-bracket taxpayers shortly before an audit is settled, or from low-bracket to high-bracket taxpayers shortly before a refund claim is expected to be granted. In an extreme case (*e.g.*, a partnership among high-

⁷⁴ This detriment to the partner will frequently produce a windfall to the government. For example, if the former partner sold its interest to the current partner at a capital gain equal to the allocable share of an ordinary income Partnership Adjustment, the only tax cost to the government from the prior misreporting would be the rate differential on the gain. Nevertheless, the government will collect the same amount again from the current partner at the time of the Partnership Adjustment, and the ultimate balancing of the books between the government and taxpayers may produce a substantial timing benefit for the fisc.

⁷⁵ ELP imputed underpayments are determined on the basis of prior audit year tax rates.

bracket affiliates), an ELP could be created with a view to taking aggressive positions with respect to underreporting income, with a plan to subsequently sell the ELP interests to low-bracket or other judgment-proof purchasers before any audit was concluded.⁷⁶

Until anti-abuse regulations are promulgated, the potential also exists to arbitrage the ELP Rules through the use of amended returns. For example, if an amended return produces a negative Partnership Adjustment, current partners will receive the resulting benefit based on their respective tax rates in the year the Partnership Adjustment takes effect. Thus, ELPs with tax-exempt partners could aggressively overreport taxable income and then file amended returns that correctly report their (lower) taxable income. If tax-exempt partners were to transfer their partnership interests to high-tax-bracket individuals or entities before the negative adjustment resulting from the amended return takes effect, the transferee partners' tax savings from the negative Partnership Adjustment would likely exceed the tax-exempt partners' tax cost for their overstated income.

Similarly, if a decrease in tax rates is anticipated in year 2, an ELP might aggressively limit its reported income in year 1 and file an amended return in year 2 reporting the additional year 1 income (which would apparently be taxable at year 2 rates even if the ELP's partners remain the same). By contrast, if an increase in tax rates is anticipated in year 2, an ELP might overreport income in year 1, file an amended return in year 2 claiming less income in year 1, and permit its partners to obtain tax refunds at the year 2 tax rates, even though tax on the income had been paid at the lower year 1 tax rates. The Secretary will no doubt promulgate the usual plethora of complex anti-abuse rules thought to be necessary and sufficient to prevent these and other abusive results through manipulation of the ELP Audit Rules.⁷⁷

⁷⁶ Query whether the same result could be achieved in part, without taxable gain to the existing partners, through the issuance of new partnership interests to low-bracket partners, thereby diluting the interests of the former high-bracket partners.

⁷⁷ Section 6255(g) authorizes the Secretary to prescribe regulations "to prevent abuse through the manipulation" of the ELP Rules.

VII. ELP AUDIT PROCEDURES

A. Statute of Limitations for Adjusting ELP Partnership Items

Absent an agreement extending the statute of limitations, the IRS cannot adjust an ELP partnership item more than three years after the later of (i) the filing of the relevant ELP return or (ii) the last day for filing the relevant ELP return.⁷⁸ The ELP, acting through its representative, has the sole authority to extend the statute of limitations for all partnership items, and any extension by the ELP binds all partners.⁷⁹ If an ELP omits more than 25% of its stated gross income from its taxable income in any taxable year, the statute of limitations for that taxable year is automatically extended to six years, and in the case of a fraudulent or false partnership return with intent to evade tax or a failure to file a return for a taxable year, the statute of limitations for that taxable year does not close.⁸⁰

B. Adjustments of ELP Partnership Items

The IRS is authorized to make adjustments at the entity level to ELP partnership items to the extent necessary in order to properly reflect the item.⁸¹ Section 6247(a) allows an IRS notice of partnership adjustment to be challenged within 90 days after notice is mailed to the partnership. However, only the ELP, acting through its representative, can petition for a readjustment of partnership items.⁸² The petition can be filed in the Tax Court, the United States district court for the district in which the partnership's principal place of business is located, or the Claims Court, assuming the rules of the relevant court are satisfied.⁸³ An

⁷⁸ I.R.C. § 6248(a).

⁷⁹ I.R.C. §§ 6248(b), 6255(b).

⁸⁰ I.R.C. § 6248(c).

⁸¹ I.R.C. § 6245(a).

⁸² I.R.C. §§ 6247(a), 6255(b)(1).

⁸³ I.R.C. § 6247(a). In order for an ELP to file a petition in the United States district court or the Claims Court for review of a partnership adjustment, the ELP must first deposit the imputed underpayment amount with respect to the adjustments under review. Such amount

ELP with a principal place of business outside the United States is treated as located in the District of Columbia.⁸⁴ The court with which a petition is filed would have jurisdiction to determine the tax treatment of all partnership items and the proper allocation of the items among the ELP partners, in addition to those items listed in the IRS notice.⁸⁵ Once a petition is filed, the IRS cannot collect any part of a deficiency from either the ELP or its partners until the relevant court's decision is final.⁸⁶

Normally, a partnership or any partner may separately file a request for an administrative adjustment of a partnership item (an "RAA").⁸⁷ The ELP Rules, however, permit only the ELP, acting only through its representative, to file an RAA.⁸⁸ The RAA must be filed before a notice of partnership adjustment is mailed to the ELP and within three years of the later of (i) the date the ELP return was filed or (ii) the last day for filing the ELP return (determined without regard to extensions).⁸⁹ If the ELP agreed to extend the statute of limitations under Section 6248(b), the period during which time it can file a RAA is extended for six months after the expiration of the extension, provided no notice of adjustment was mailed before the RAA filing.⁹⁰

If the IRS disallows any part of an RAA, only the ELP, acting through its representative, is permitted to file a petition for an adjustment of the disallowed portion with the Tax Court, the United States district court for the district in which the ELP's principal place of business is located, or the Claims Court.⁹¹ The

will not be treated as a payment of tax for accrual of interest purposes. I.R.C. § 6247(b).

⁸⁴ I.R.C. § 6255(c).

⁸⁵ I.R.C. § 6247(c).

⁸⁶ I.R.C. § 6246(a)(2).

⁸⁷ I.R.C. §§ 6227(a), (c).

⁸⁸ I.R.C. § 6251(a).

⁸⁹ I.R.C. §§ 6251(a)(1), (2).

⁹⁰ I.R.C. § 6251(c).

⁹¹ I.R.C. § 6252(a). Unlike a petition for judicial review based on an IRS notice of adjustment, an ELP does not have to deposit an imputed underpayment amount before petitioning a United States

petition must be filed no earlier than six months and no later than two years after the date the RAA is filed.⁹² The court's jurisdiction is limited to the items disallowed by the IRS and items the IRS seeks to adjust as offsets to the adjustments requested by the ELP.⁹³ If the ELP files a petition for judicial review of a disallowed RAA, and the IRS subsequently mails a notice of adjustment, the petitioned court's jurisdiction is expanded to include the items adjusted in the notice.⁹⁴

C. Participation in Audits Limited to ELP Representative

Each ELP must designate a partner, or other person⁹⁵ (the "Tax Matters Partner" or the "Representative"), who will have the sole authority to act on behalf of the ELP in all proceedings brought under the ELP Audit Rules.⁹⁶ The ELP and its partners will be bound by the decisions and actions taken by the Representative in proceedings under the ELP Audit Rules, and individual partners have no right to participate in settlement negotiations or request refunds.⁹⁷ By contrast, each partner in a partnership other than an ELP may participate in all partnership proceedings relating to the determination of partnership items.⁹⁸ If an ELP fails to designate a Representative, the IRS may designate

district court or the Claims Court for judicial review where an RAA has been denied.

⁹² I.R.C. § 6252(b). The Secretary is authorized to extend the time to file an RAA beyond the normal two-year limit by agreement with the partnership.

⁹³ I.R.C. § 6252(d).

⁹⁴ I.R.C. §§ 6252(c)(2), (d); *see also* I.R.C. § 6247(c).

⁹⁵ The ELP Rules permit a nonpartner to be appointed as an ELP's Representative. This marks a significant departure from the usual partnership provisions, which provide that the "Tax Matters Partner" is a general partner designated by the partnership, or in the absence of any such designation the general partner with the largest profits interest at the end of the taxable year. *See* I.R.C. § 6231(a)(7).

⁹⁶ I.R.C. § 6255(b)(1).

⁹⁷ I.R.C. § 6255(b)(2); 1997 Senate Report at 248.

⁹⁸ I.R.C. § 6224(a).

any one of the partners as the ELP's Representative until the ELP designates a replacement Representative.⁹⁹

The IRS is not required to give notice to individual partners of an ELP when it commences a partnership administrative proceeding or a final Partnership Adjustment. Rather, the IRS needs only to mail notice (by certified or registered mail) of such a proceeding to the ELP's last known address, even if the ELP had previously terminated its existence.¹⁰⁰ By contrast, the IRS is generally required to give notice of the commencement of a partnership administrative proceeding and any resulting adjustments to all partners whose names and addresses are furnished to the IRS.¹⁰¹ However, with respect to a partnership with more than 100 partners that does not make an ELP Election, the IRS is no longer required to give notice to any partner holding less than a 1% profit interest.¹⁰²

By electing ELP status, all partners other than the Representative forego any ability to participate in settlement negotiations, request refunds, file RAAs, or to seek judicial review of IRS adjustments. All partners in an ELP are bound by the Representative's actions in proceedings with the IRS and the courts. This restriction applies equally to both current and former partners in the ELP. The choice of the Representative, and whether the Representative is accountable to a management committee, is therefore an important consideration for the partners of an ELP (and a partnership that is not currently, but may become, an ELP).

Even if the ELP decides that it, rather than its current partners, will satisfy Partnership Assessments, the lack of direct partner participation in an audit may preclude adequate representation of partners where the audit concerns a reallocation of income between two or more partners, particularly if former partners are affected. The ELP Rules fail to take into account that it is simply not possible for a single Representative to fairly and

⁹⁹ I.R.C. § 6255(b)(1).

¹⁰⁰ I.R.C. § 6245(b)(1).

¹⁰¹ I.R.C. § 6223(a).

¹⁰² I.R.C. § 6223(b).

effectively represent more than one partner in connection with a reallocation that will necessarily benefit one or more partners at the expense of other partners.

Consideration should be given to requiring the Representative to act only at the direction of a management committee, although even this falls short of an optimal solution. Accordingly, the partners of an ELP may also wish to provide in their partnership agreement that, at minimum, 51% of the partners (determined on the basis of their capital interests) shall be entitled to replace the original Representative at any time (preferably by a vote evidenced by a writing signed by each voting partner), whether or not the Representative is willing and able to continue. The partners with the largest equity interests could then choose a new Representative, who would continue in the role, unless, and until, the partners choose another new Representative. The largest current partners could thereby retain effective, yet indirect, participation in the IRS proceedings.

If a majority of the partners cannot agree on a Representative, a default provision in the partnership agreement could appoint the partner with the largest capital interest as the Representative, so long as that partner is available and willing to undertake the position. Providing partners with additional flexibility to choose and replace the Representative is important because it would address the often encountered problems of the Representative (the “Tax Matters Partner”) being difficult to locate, having no substantial continuing partnership interest, and being bankrupt by the time a partnership audit occurs.¹⁰³

¹⁰³ See, e.g., *Starlight Mine v. Comm’r*, T.C. Memo 1991-59 (holding that a Tax Court petition filed by a nonpartner after the death of a Tax Matters Partner (“TMP”) was defective, and granting the partnership leave to designate a TMP to ratify the petition); *AMRB Assocs. v. Comm’r*, T.C. Memo 1991-450 (holding that a Tax Court petition filed by a corporate TMP that had previously dissolved was invalid and directing the partnership to appoint a substitute TMP to ratify the invalid petition); *Sept. Partners v. Comm’r*, T.C. Memo 1990-33 (holding that a Tax Court petition filed by a TMP who had previously filed a bankruptcy petition was a nullity and directing the limited partners to appoint a new TMP).

VIII. OPEN QUESTIONS REGARDING ELPS

A. Testing Date for ELP Status

It is not clear whether the ELP Audit Rules apply if a partnership that is currently an ELP was not an ELP with respect to one or more of the taxable year(s) under audit. In the absence of further guidance, a partnership that elected ELP treatment after the year under audit could be subject to the ELP Audit Rules even if the partnership was not an ELP during the taxable year being audited. Since current partners are liable for Partnership Adjustments under the ELP Rules, former partners who were partners in the year under audit could receive an unexpected release from any resulting tax assessments simply because the partnership became an ELP in a subsequent year. Of course, forthcoming regulations may provide that the ELP Audit Rules will only apply if the partnership was an ELP in the year under audit.

It is also not clear whether the ELP Audit Rules apply to a partnership that is audited for a prior year in which it was an ELP, if the partnership is no longer an ELP (*e.g.*, because it has less than 100 partners) at the time of the audit. If a partnership that is not currently an ELP was not subject to the ELP Audit Rules for the audit of a prior year in which it was an ELP, the current partners could escape tax liability for such year, since the TEFRA Rules assess the additional tax liability to the (former) partners who were partners during the year under audit. However, since a partnership that elects ELP treatment cannot revoke its ELP Election without the consent of the Secretary, there is limited opportunity for the partners of an ELP to escape current partner tax liability by revoking its ELP Election prior to audit.¹⁰⁴ On the other hand, if such a partnership were subject to the ELP Audit Rules, such treatment would stand in direct contradiction to the usual partnership rules that assess liability for partnership adjustments against the (former) partners during the year under audit.

¹⁰⁴ However, since Section 775(a) states that, to the extent provided in regulations, a partnership will cease to be treated as an ELP for any partnership taxable year in which there were less than 100 partners, the ELP partners could attempt to avoid ELP Audit Rules by consolidating their interests to the point where there were less than 100 partners.

Consequently, all acquirors of partnership interests should determine whether the partnership was an ELP at any previous time before purchase, since they could be held liable for tax adjustments relating to prior years under the ELP Rules, even when the partnership they are buying into is not currently an ELP.

B. Tax Treatment of ELPs that are Partners in Other Partnerships

The TEFRA rules do not apply to ELPs, other than in an ELP's capacity as a partner in other partnerships that are not themselves ELPs.¹⁰⁵ If an ELP is a partner in another partnership that is not an ELP, the TEFRA rules will apply to the ELP's allocable shares of items that are partnership items of the non-ELP partnership. Any adjustments from such other partnerships are passed through by the ELP to its partners.¹⁰⁶

For example, assume Partnership A ("A") is a 25% partner in Partnership B ("B"). B was never an ELP. A was an ELP beginning in 1998. In 2001, B is audited for the 1999 tax year, and B is assessed an additional \$100 of income for 1999. Since A was a partner in B in 1999, the year under audit, A must recognize an additional \$25 of income. (Even if A disposed of its entire interest in B in 2000, A would still be responsible for an additional \$25 under the normal audit adjustment rules since A was a partner during 1999, the year under audit.) Since A is an ELP, A would pass through its \$25 adjustment to its current partners (*i.e.*, those owning interests in A in 2001). If Joe was an individual partner in A in 1999, and he sold his entire interest in A to Sally in 2000, Sally, as the current partner, would be liable for her share of the \$25 adjustment incurred by A in 2001, and Joe would have effectively escaped additional tax liability as a result of A's status as an ELP.

C. Definition of Former Partners of Liquidated ELPs

It is not clear whether regulations providing for the collection of Partnership Adjustments from former partners of previously liquidated ELPs will define former partners as the

¹⁰⁵ I.R.C. § 6240(b)(1).

¹⁰⁶ I.R.C. § 6240(b)(2).

partners when the partnership liquidates, during the partnership's tax year to which the adjustment relates, or during some other specified time. If former partners were defined as those when the partnership liquidates, taxpayers might gain a tax advantage from redemptions of all taxable partners in one year and income recognition followed by liquidation of the partnership in the next year. If former partners were defined as those who held partnership interest during the partnership's tax year to which the adjustment relates, current partners could liquidate prior to a Partnership Adjustment in order to shift the additional tax to those former partners. Consequently, regulations may be expected to limit the definition of former partners to those who are partners at the time a partnership plan of liquidation is formally or informally adopted, particularly if the plan contemplates sequential redemptions of partnership interests.

D. Change of Character ELP Partnership Adjustments

The ELP Rules provide little guidance regarding the effect of partnership adjustments that involve a change in the character of items of income, gain, loss or deduction. Absent further guidance, it is likely that disagreements between partnerships and audit agents regarding these items will have to be resolved by the courts.

Forthcoming regulations will need to adopt broad rules governing these adjustments in order to assure that the correct aggregate tax is paid without investigating each partner's tax return for the year an item was incorrectly reported. Any attempt to devise a general rule that imposes liability on either current partners or partnerships for adjustments recharacterizing previously reported items will necessarily be arbitrary. As a result, these rules may impose and collect a tax liability on "innocent" errors that exceeds the actual revenue loss to the government, and may create tax planning opportunities for aggressive taxpayers.

For example, if an ELP misreports ordinary income as capital gain, partners to whom the capital gain was actually allocated may have underpaid tax by amounts ranging from 5% to 38.6% of the misreported amount, based on current tax rates.¹⁰⁷ A

¹⁰⁷ Individuals in the 15% tax bracket without offsetting ordinary or capital losses could have underpaid tax by 5% of the misreported

broad rule might fairly treat former partners in the partnership as having paid a flat 20% tax on capital gain items recharacterized as ordinary income items. Thus, current corporate partners in the highest bracket without net operating losses and capital losses would have a liability of 15% of their allocable shares of the adjustment, and current individual partners in the highest bracket without net operating losses and capital losses similarly would have a liability of 18.6% of their allocable shares. A partnership choosing to pay an assessment at the partnership level would have a liability of 18.6% of the amount of the misstated item. These results would seem generally correct in most cases.

Similarly, recharacterizations of an ELP's passive income or loss as investment income or loss (or vice versa), or the redetermination of an ELP's alternative minimum taxable income (though not strictly a character issue) will likely also require an arbitrary rule. It is difficult to devise a simple yet principled way to determine the actual tax effect of the original characterizations. One possible, albeit arbitrary rule would assume that the initial, incorrect treatment of the item reduced the tax of each former partner by 50% of the highest regular or alternative minimum tax rate applicable to individuals or corporations for the initial year (had the income items been properly characterized) for purposes of computing the amount of the resulting Partnership Adjustment.

amount (the difference between their ordinary income rate (15%) and their capital gains rate (10%)). Individuals in the highest tax bracket without offsetting ordinary or capital losses could have underpaid tax by 18.6% of the misreported amount; corporations with capital but not ordinary losses could have underpaid tax by 35% of the misreported amount; individuals with capital but not ordinary losses could have underpaid tax by 38.6% of the misreported amount. Taxpayers with capital losses not otherwise currently useable, but available to carry forward for use at some future time, could have underpaid tax by any amount between 5% and 38.6% of the misreported amount.

**IX. ALLOCATION OF ELP PARTNERSHIP
ADJUSTMENTS AND RESULTING INCREASES TO
EACH PARTNER'S CAPITAL ACCOUNTS AND
INSIDE BASIS**

Among the most important questions the ELP Rules do not answer is how the deemed liability for a Partnership Assessment paid by an ELP is to be allocated among its partners, and how liability for a Partnership Assessment paid by the partners of an ELP may be allocated among those partners. Guidance is urgently needed regarding (i) permissible allocations of Partnership Adjustments, and in the case of partnership payments, allocations of deemed liability for Partnership Assessments, and (ii) proper corresponding adjustments to each partner's capital accounts and partnership interest basis.¹⁰⁸ In the absence of guidance, one reasonable framework that ELPs may employ is described below.

**A. Allocations and Adjustments When ELPs Satisfy
Partnership Assessments**

If an ELP satisfies a Partnership Assessment, the allocation of the Partnership Assessment (and of related Partnership Adjustments) among the partners may not be immediately important, but it is nonetheless meaningful, because the allocation will affect partners' future cash distributions made in accordance with partners' Section 704(b) capital accounts. In addition, the allocation of the Partnership Assessment will affect each partner's basis in its ELP interest, and it therefore will affect eventual gain or loss on a sale of that interest.

In the absence of guidance, an ELP paying a Partnership Assessment should be permitted to specially allocate such assessment (and related Partnership Adjustments) in any manner that has substantial economic effect (or otherwise ultimately

¹⁰⁸ Guidance regarding allocations should not affect any sharing of income and liabilities agreed to by partners. If the IRS determines that an ELP's allocations are inconsistent with the Section 704(b) Treasury Regulations, a reallocation of the inconsistent items should be subject to the provisions of Section 6241(c)(2). ELPs may elect to provide for indemnification of partners in the event of a reallocation, which in turn raises issues regarding the tax effect of such indemnity payments.

affects cash distributions to its partners). However, regulations should be expected to give special scrutiny to allocations shifting a greater portion of the allocated items to partners in higher tax brackets than would occur under the partnership's general allocation rules (thus maximizing the tax benefits to the partners of the resulting asset basis adjustments discussed below).

To avoid inconsistent allocations when the ELP and its partners each pay different assessments, the same type of default allocation should be used to allocate Partnership Assessments paid by both ELPs and their partners. If an ELP pays a Partnership Assessment, one possible construct would provide: (i) the Partnership Assessment should be treated as an item of ELP expense in the current year for purposes of allocating items of ELP income, gain, loss and deduction among the partners, (ii) the Partnership Assessment should be treated as the last item of loss or deduction allocated in the current year, and (iii) the Partnership Adjustment should be allocated among the partners in the same manner as the Partnership Assessment was allocated (such rule, the "Default Allocation Rule").

The ELP Rules provide no guidance regarding the adjustments to partners' bases and capital accounts that follow from an ELP's payment of Partnership Assessments. Conceptually, each partner's tax capital account and partnership interest basis properly should be increased (under principles similar to those applied in the case of tax-exempt income) by that partner's allocable share of any Partnership Adjustments; partners' Section 704(b) capital account balances should not be affected by the allocation of Partnership Adjustments.¹⁰⁹

An ELP's payment of a Partnership Assessment should be treated as a deemed distribution of cash to its partners, and the ELP's payment of an assessment for which it alone is liable should be treated as a Section 705(a)(2)(B) nondeductible partnership expense. In either case, each partner's basis, tax capital account

¹⁰⁹ In such case, the additional deemed asset created by the Partnership Adjustment could be treated as having a value and book basis of zero for Section 704(b) capital account purposes and applying Section 704(c) principles to the resulting difference between partners' book and tax capital accounts.

and Section 704(b) capital account should each be decreased by the partner's allocable share of the payment. Interest and penalties paid by an ELP should also be treated as nondeductible partnership expenses that reduce each partner's basis, tax capital account and Section 704(b) capital account.¹¹⁰

B. Allocations and Adjustments When Current Partners Satisfy Partnership Assessments

If the current partners of an ELP pay a Partnership Assessment, the allocation among the partners of the Partnership Adjustments that give rise to the assessment will determine the partners' liability for the assessment. In the absence of regulations to the contrary, an ELP should be permitted to specially allocate such Partnership Adjustments in any manner that is consistent with the allocation of another material item of its income or loss.¹¹¹

Forthcoming regulations will likely provide a default rule that would apply if an ELP's governing documents do not specifically allocate Partnership Adjustments among its partners, and perhaps if the IRS disallows an ELP's special allocation. Partners' liability for, and payment of, Partnership Assessments could also be allocated under such a rule in the same manner as an allocation of Partnership Assessment paid by the ELP would have been allocated among the partners had the ELP paid the assessment, with the corresponding Partnership Adjustments allocated among the partners in the same manner. These allocations would reflect the economic reality that a Partnership Adjustment is, in substance, a current year loss for the partners that bear the tax on the Partnership Adjustment, because the assessment has no value and carries with it a tax liability. Alternatively,

¹¹⁰ No deduction is allowed for any payment required to be made by an ELP under Section 6242. I.R.C. § 6242(e).

¹¹¹ Allocations shifting a greater portion of the liability for an assessment to partners in lower tax brackets or to partners with clearly insufficient resources, rather than under the partnership's general allocation rules, would likely attract special scrutiny.

Partnership Adjustments could be allocated in the manner in which items of income are shared by the partners in the current year.¹¹²

The ELP Rules do not specifically require adjustments to be made to each partner's tax capital account and partnership interest basis in a manner that conforms to a partnership's chosen allocation. Absent regulations to the contrary, the allocation of Partnership Adjustments among partners would presumably result in a positive adjustment, equal to the partner's share of the Partnership Adjustment, to each partner's tax capital account and the partner's tax basis in its partnership interest in the year the assessment takes effect. No adjustment would presumably be made to the partners' Section 704(b) capital accounts in connection with the allocation.

C. Illustration of an Allocation Framework

The allocations discussed above, while simple in concept, may produce unexpected results, as illustrated by the following example: Assume that limited partners invest 99%, and the general partner 1%, of the capital in an ELP partnership. The ELP's net profits¹¹³ are allocated 99% to the limited partners and 1% to the general partner until the limited partners have obtained a specified return, and thereafter, 50% to the general partner and 50% to the limited partners. Net losses are allocated in proportion to capital account balances. In a year in which the ELP had net losses, and the ratio of the capital account balances of the limited and general partners was 99 to 1, the ELP erroneously expensed capital items. In the year the Partnership Assessment takes effect and is paid by the ELP, net profits are allocated 50% to the general partner and 50% to the limited partners. Capital account balances at the end of that year are in the ratio of 30% for the general partner and 70% for the limited partners.

¹¹² Such an allocation would less clearly reflect the economic reality that Partnership Adjustments, being phantom income, do not represent the same value generally attributed to items of income.

¹¹³ Net profit and net loss would presumably be computed for this purpose without regard to items of income allocated pursuant to minimum gain chargebacks of partnership nonrecourse debt or of partner nonrecourse debt.

If the Partnership Assessment is allocated to the partners that would bear the loss if the ELP's payment of the assessment were treated in the same manner as the ELP's payment of other current year expenses, it would be allocated (after the allocation of all other items) 50% to the general partner and 50% to the limited partners to the extent of the ELP's net profits for the current year, if any, and then 30% to the general partner and 70% to the limited partners.¹¹⁴ Solely for purposes of maintaining partners' tax capital accounts, the Partnership Adjustments would then be allocated among the partners in the same manner as the Partnership Assessment was allocated, *i.e.*, in an appropriate ratio between 50% and 70% to the limited partners and between 50% and 30% to the general partner, depending on whether, and by how much, the Partnership Assessment exceeds the ELP's net profits in the current year.

D. Correlative ELP Asset Basis Adjustments

The ELP Rules do not specifically address whether a Partnership Assessment produces additional basis in partnership assets, or, if so, how any additional basis should be allocated. However, the netting concept employed by the ELP Rules clearly contemplates that a Partnership Adjustment requiring the capitalization of an improperly expensed item creates additional basis in the asset during the period between the audited year in which the asset should have been capitalized and the year the assessment takes effect. The ELP should be permitted to depreciate or amortize any additional basis remaining after the year with respect to which the deduction is disallowed (to the extent consistent with general tax principles). Conceptually, deductions attributable to such subsequent depreciation or amortization should be allocated to the partners in the same manner as the allocation of

¹¹⁴ The Partnership Assessment (and the Partnership Adjustment) could also be allocated 99% to the limited partners and 1% to the general partner. The Partnership Assessment would be then visited upon the partners that benefitted from the initial error (or their successors). Such a rule may be preferable if transfers of interests in the intervening years have been minimal, and successors have obtained indemnities from the selling partners. ELPs choosing to allocate assessments in this manner would need to separately ensure that the allocations would affect cash distributions to partners.

deemed or actual liability for the assessment,¹¹⁵ which allocation would be consistent with Section 704(c) principles.¹¹⁶

If deductions are not allocated in this manner, partners that have been allocated actual or deemed liability for a Partnership Assessment in the manner discussed above would bear current tax and would realize only decreased capital gain (or an increased capital loss) on subsequent sales of their ELP interests, a benefit that would generally be worth substantially less than the tax liability borne by the partners (which may be paid by the ELP).¹¹⁷

X. THE MERITS AND DEMERITS OF ELP ELECTIONS

Since an ELP Election is effective for all subsequent tax years unless and until the Secretary consents to its revocation, it is important for a partnership to carefully consider the long-term effects of making the election. This decision should be informed

¹¹⁵ The effect of Section 754, if partnership interests are transferred during the period in question, would create additional complexities not discussed herein.

¹¹⁶ The treatment of the proper correlative adjustment may be illustrated as follows: Assume a partnership deducted a 100 expense it should have capitalized and amortized over ten years. Five years later, the IRS denies the deduction and issues a Partnership Assessment. Because half the asset's basis could have properly been amortized before the assessment, the net assessment should equal the tax on 1/2 of the disallowed expense, *i.e.*, a tax on 50. (The ELP's interest obligation should be computed as if the ELP had a deficiency of the tax on 90 in year 1 and had received a refund of the tax on 10 a year for years 2 through 5.) Thus, a 10% partner would be required to pay tax on 5 of income. The partnership would amortize its additional 50 of basis over the next five years, and the 10% partner would be entitled to 10% of the additional 10 of deductions in each year.

¹¹⁷ The capital loss would also have less value than the ELP's continued deduction of an improperly expensed item (if a Partnership Adjustment requiring the item to be capitalized had been deferred), because the netting of under- and over-payments effectively results in an ordinary deduction for each year between the year the item was expensed and the year the adjustment takes effect.

by careful consideration of the circumstances under which the ELP Rules may be detrimental to its tax position in future years. Moreover, the governing agreements of all partnerships that qualify, or may qualify, as ELPs should include provisions detailing how the partnership will decide whether to make an ELP Election if it becomes eligible to do so. All partnerships should give consideration to this issue, regardless of their initial ability to qualify for ELP status, since many partnerships may eventually qualify to elect ELP status.

For example, in the case of partnership interest transfers during a taxable year, both the transferors and transferees of the interests are counted as partners for purposes of determining whether a partnership is eligible to make an ELP Election.¹¹⁸ Now that the check-the-box regime has permitted partnerships to relax their restrictions on transfers of partnership interests, transfers will likely play a larger role in whether a partnership may make the ELP Election. Moreover, since qualification is determined retroactively, a partnership may wish to employ transfers at year-end to permit an earlier ELP Election, if the partnership expects to have more than 100 partners in future years.

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¹¹⁸ See H.R. Rep. No. 353, 103d Cong., 1st Sess. 55 n.9 (1993).