



Section of Taxation

10th Floor
740 15th Street, N.W.
Washington, DC 20005-1022
202-662-8670
FAX: 202-662-8682
E-mail: tax@abanet.org

June 11, 2009

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Concerning Proposed Regulations Under Section 6231(c) Relating to the
Conversion of Partnership Items to Nonpartnership Items

Dear Commissioner Shulman:

Enclosed are comments concerning the proposed regulations under section 6231(c) of the Internal Revenue Code relating to the conversion of partnership items to nonpartnership items with respect to certain tax avoidance transactions. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

A handwritten signature in black ink, appearing to read "Stuart M. Lewis".

Stuart M. Lewis
Chair - Elect, Section of Taxation

Enclosures

cc: Eric A. San Juan, Acting Tax Legislative Counsel, Department of the Treasury
Clarissa C. Potter, Acting Chief Counsel, Internal Revenue Service
Deborah A. Butler, Associate Chief Counsel (P&A), Internal Revenue Service
William A. Heard, Senior Counsel, Branch 7, Office of Chief Counsel (P&A), Internal Revenue Service
Robert T. Wearing, Office of Associate Chief Counsel (P&A), Internal Revenue Service

CHAIR
William J. Wilkins
Washington, DC

CHAIR-ELECT
Stuart M. Lewis
Washington, DC

VICE CHAIRS
Administration
Rudolph R. Ramelli
New Orleans, LA
Committee Operations
Peter J. Connors
New York, NY
Communications
Ellen P. Aprill
Los Angeles, CA

Government Relations
Armando Gomez
Washington, DC

Professional Services
Samuel L. Braunstein
Fairfield, CT

Publications
Louis A. Mezzullo
Rancho Santa Fe, CA

SECRETARY
Alice G. Abreu
Philadelphia, PA

ASSISTANT SECRETARY
Brian P. Trauman
New York, NY

COUNCIL
*Section Delegates to the
House of Delegates*
Paul J. Sax
San Francisco, CA
Richard M. Lipton
Chicago, IL

Immediate Past Chair
Stanley L. Blend
San Antonio, TX

MEMBERS
Christine L. Agnew
Washington, DC

John P. Barrie
New York, NY

Peter H. Blessing
New York, NY

Walter Burford
Atlanta, GA

Thomas J. Callahan
Cleveland, OH

William H. Caudill
Houston, TX

Leslie E. Grodd
Westport, CT

C. Wells Hall, III
Charlotte, NC

Thomas R. Hoecker
Phoenix, AZ

Helen M. Hubbard
Washington, DC

Kathryn Keneally
New York, NY

Emily A. Parker
Dallas, TX

Priscilla E. Ryan
Chicago, IL

Stephen E. Shay
Boston, MA

LIAISON FROM ABA
BOARD OF GOVERNORS
Lee S. Kolczun
Sheffield Village, OH

LIAISON FROM ABA
YOUNG LAWYERS DIVISION
Jackie J. Cook
Detroit, MI

LIAISON FROM LAW
STUDENT DIVISION
Cynthia Kahl
Berkeley, CA

DIRECTOR
Christine A. Brunswick
Washington, DC

**AMERICAN BAR ASSOCIATION SECTION OF TAXATION
COMMENTS CONCERNING PROPOSED REGULATIONS UNDER
SECTION 6231(c) RELATING TO THE CONVERSION OF
PARTNERSHIP ITEMS TO NONPARTNERSHIP ITEMS**

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Kevin R. Stults of the Section’s Administrative Practice Committee. Substantive contributions were made by Rochelle Hodes. These Comments were reviewed by Ron Buch, Chair of the Administrative Practice Committee and R. Brent Clifton, Chair of the Partnerships and LLCs Committee. These Comments were further reviewed by Thomas J. Callahan, of the Section’s Committee on Government Submissions, Emily Parker, Council Director for the Administrative Practice Committee, and William H. Caudill, Council Director for the Partnerships and LLCs Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact: Kevin R. Stults
 (202) 327-2131
 kstults@mckeenelson.com

Date: June 11, 2009

EXECUTIVE SUMMARY

On February 13, 2009, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issued proposed regulations (the “Proposed Regulations”)¹ that would allow the Service to convert partnership items to nonpartnership items, where the application of the unified partnership audit and litigation procedures of sections 6221 through 6234 (the “TEFRA Partnership Procedures”)² with respect to certain tax avoidance transactions interferes with the effective and efficient enforcement of the internal revenue laws. The preamble to the Proposed Regulations states that special enforcement considerations, within the meaning of section 6231(c)(1)(E), are present in the case of transactions that Treasury and the Service have identified as listed transactions. The Proposed Regulations would allow the Service to determine unilaterally, on a partnership-by-partnership and partner-by-partner basis, whether to convert partnership items to nonpartnership items.

Although we applaud the government’s continuing focus on transactions that offer potential for tax abuse, we nevertheless believe that the Proposed Regulations are inconsistent with the original goals of the TEFRA Partnership Procedures, do not effectively address the problems the Service identifies in the preamble, grant the Service too much unilateral discretion, and would expose the Service to further litigation, delay, and expense. We therefore recommend that the Proposed Regulations be withdrawn or modified as suggested in these Comments to restore the balance Congress desired between effective and efficient tax administration and protecting taxpayers’ rights.

¹ Prop. Reg. § 301.6231(c)-9, 74 Fed. Reg. 7205-01 (Feb. 13, 2009).

² All references to “section” herein are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise expressly stated herein, and references to Regulations are to the Treasury Regulations promulgated under the Code..

DISCUSSION

I. Introduction.

A. The Proposed Regulations.

The preamble to the Proposed Regulations expresses concern that the application of the TEFRA Partnership Procedures to the recent generation of tax avoidance transactions, specifically listed transactions within the meaning of Regulation section 1.6011-4(b)(2), often results in multiple, complex proceedings that consume significant administrative resources.³ It notes that whereas the tax shelters of the 1970s used a single partnership with tens or hundreds of investors, the more recent tax shelters used combinations of multiple pass-through entities for the benefit of a few investors.⁴ Because the TEFRA Partnership Procedures determine the tax treatment of items at the partnership level first, both entity-level and partner-level proceedings are sometimes required, placing an “unnecessary burden on taxpayers, the IRS, and the federal courts.”⁵ The Proposed Regulations state that Treasury and the Service have therefore determined that treating items related to listed transactions as partnership items interferes with the effective and efficient enforcement of the internal revenue laws.⁶ As a result, special enforcement considerations exist that allow the promulgation of regulations by which partnership items can be converted to, and treated as, nonpartnership items.⁷

The Proposed Regulations would allow the Service to convert partnership items that relate to a listed transaction to nonpartnership items on a partner-by-partner and partnership-by-partnership basis.⁸ Upon written notice, all partnership items of a partner attributable to the identified partnership must be converted, but the Service is not required to convert the partnership items of any other partners.⁹ If a notified partner holds an interest in the partnership identified in the notice through a pass-thru partner, the partnership items attributable to the identified partnership that flow through the pass-thru partner will be treated as nonpartnership items.¹⁰ Two examples are provided that illustrate these provisions. The first example clarifies that where a partner has an interest in two different partnerships, the Service can convert the partnership items in one partnership but not the other.¹¹ The second example concerns the application of the

³ Preamble to the Proposed Regulations, 74 Fed. Reg. 7205-01, 7206 (Feb. 13, 2009).

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*; Prop. Reg. § 301.6231(c)-9(a).

⁷ I.R.C. § 6231(c)(1)(E), (c)(2).

⁸ Prop. Reg. § 301.6231(c)-9(a).

⁹ *Id.*

¹⁰ *Id.*

¹¹ Prop. Reg. § 301.6231(c)-9(b), Ex. 1.

Proposed Regulations where a partner has an indirect interest in a partnership through a pass-thru partnership. This example demonstrates that the partnership items in the pass-thru partnership that are not attributable to the partnership that is the subject of the written notification remain unconverted.¹²

B. Listed Transactions.

Since February 28, 2000, the reportable transaction disclosure regime has included listed transactions as one category of transactions requiring special disclosure. “Listed transactions” are transactions that Treasury and the Service identify in published guidance as tax avoidance transactions.¹³ The definition of listed transactions also includes transactions that are “substantially similar” to a listed transaction.¹⁴ The regulations define a transaction as substantially similar to a listed transaction if it is “expected to obtain the same or similar types of tax consequences” and “is either factually similar or based on the same or similar tax strategy.”¹⁵ The precise meaning of “substantially similar” is beyond the scope of these Comments, but that term is subject to different interpretations depending on the context of the transaction. For purposes of these Comments, it is enough to note that while the Service has provided little guidance to help clarify what makes a transaction “substantially similar” to a listed transaction, both Treasury and the Service construe the phrase broadly in defining a listed transaction.¹⁶

Identification of a transaction as a listed transaction is a powerful tool available to the Service, with few limitations. First, the rules defining listed transactions and governing how and when the Service will identify them are provided by regulation, not statute. Next, despite the fact that there are immediate disclosure obligations imposed as a result of the identification of a transaction as a listed transaction, there are no limits on *when* the Service can identify a transaction as a listed transaction (i.e., a transaction may be identified as a listed transaction at any time without warning). Thus, for example, a transaction may be required to be disclosed as a listed transaction even if the transaction is not identified by the Service as a listed transaction until many years after the return for that tax year was filed. Finally, a party may be identified as having a disclosure obligation with respect to the listed transaction even if the party's United States tax is not affected by the transaction.

The Service rightly views the identification of a transaction as a listed transaction as a useful tool for discouraging and policing aggressive tax planning. The requirement that a taxpayer must disclose a listed transaction raises the stakes for those who choose to

¹² Prop. Reg. § 301.6231(c)-9(b), Ex. 2.

¹³ Reg. § 1.6011-4(b)(2).

¹⁴ *Id.*

¹⁵ Reg. § 1.6011-4(c)(4).

¹⁶ *Id.*

enter into listed transactions by increasing their visibility to the Service. As expected, the listing by the Service actually deters many taxpayers from entering into those transactions. The Service has further bolstered the deterrent effect of listing a transaction by, for example, modifying its “policy of restraint” with respect to tax accrual workpapers for listed transactions and aggressively auditing such transactions.¹⁷ In addition, the Service puts a tremendous amount of effort and resources into auditing and litigating listed transaction cases. Congress has also supported the listed transaction regime by increasing penalties for failing to disclose listed transactions.¹⁸

For all its successes, the listed transaction regime is still, at bottom, an administratively creation established under sections 6001 and 6011—recordkeeping and return-filing statutes. Until now, the listing of a transaction had no effect on the substantive federal income tax law applicable to the transaction.¹⁹ Put differently, the listed transaction regime sets out the Service’s litigation positions with respect to the transactions the Service considers most abusive,²⁰ but the determination as to whether the Service’s position is actually correct in any given case is still a matter for the courts. The Proposed Regulations would, in our view, improperly expand the listed transaction disclosure regime into a matter of substantive law.

Although we support the government’s policing of tax abusive transactions, we recommend that the Proposed Regulations be withdrawn or modified as suggested in these Comments as: 1) they are an exception to the original purposes of the TEFRA Partnership Procedures, are not justified under the special enforcement provision, and do not properly address the problems described in the preamble; 2) they grant the Service excessive unilateral discretion to convert partnership items, thus undermining taxpayers’ rights and potentially causing taxpayers to question the fairness of the tax system generally; and 3) they would create additional administrative expense, delay, and burden for the Service, potentially increasing litigation.

II. The Proposed Regulations Are Based On An Incorrect Premise.

The Proposed Regulations are presented as a necessary solution to the increased administrative burdens (e.g., multi-tiered partnership structures) identified in their

¹⁷ Announcement 2002-63, 2002-2 C.B. 72; I.R.M. 4.10.20.3.2.3. We do not take a position in these Comments on the Service’s exception to its “policy of restraint” with respect to requests for tax accrual workpapers where one or more listed transactions may be present.

¹⁸ *See, e.g.*, American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 816(a) (amending I.R.C. § 6707), § 811(a) (enacting I.R.C. § 6707A), § 812(a) (enacting I.R.C. § 6662A) 118 Stat. 1418, 1421 (2004).

¹⁹ While listing a transaction can have important consequences (*see, e.g.*, I.R.C. § 6501(c)(10)), the listing of a transaction does not currently affect the body of federal income tax law that is applicable, *e.g.* whether the TEFRA Partnership Procedures apply.

²⁰ *See, e.g.*, Notice 95-34, 1995-1 C.B. 309 (later declared a listed transaction in Notice 2000-15) (“Taxpayers and their representatives should be aware that the Service has disallowed deductions for contributions to these arrangements, and is asserting the positions discussed above in litigation.”)

preamble. However, instead of directly addressing these problems, the Proposed Regulations ignore the overriding purposes for enacting the TEFRA Partnership Procedures and incorrectly assume that the TEFRA Partnership Procedures interfere with the effective and efficient enforcement of the internal revenue laws where a partnership undertaking is classified as a listed transaction.

A. The Proposed Regulations are Inconsistent with the Original Goals of the TEFRA Partnership Procedures.

Prior to the enactment of the TEFRA Partnership Procedures in 1982, the Service was required to audit and adjust the tax return of each individual partner in a partnership. This was administratively difficult for the Service for a variety of reasons. First, it required separate partner-level audits of tax items resulting from a single partnership-level transaction. Second, any resulting litigation was conducted on a partner-by-partner basis, allowing for inconsistent results from multiple proceedings in the Tax Court, the district courts and the Court of Federal Claims relating to a single partnership transaction. Third, the statutory period for assessment was determined on an individual, partner-by-partner basis, similarly allowing for inconsistent results.²¹ The Joint Committee on Taxation stated that the pre-1982 system resulted in “excessively burdensome” “administrative problems” due to the “fragmented nature” of partner-by-partner determinations.²² There was also little incentive for the Service to settle with one partner when the issues would have to be litigated for each other partner, and where settlement did occur it often resulted in inconsistent treatment of the same item for different partners.²³

The TEFRA Partnership Procedures were enacted to determine “the tax treatment of items of partnership income, loss, deductions, and credits” in a unified proceeding at the partnership level “rather than in separate proceedings with the partners.”²⁴ Congress created a “consistency requirement” between the partnership return and the partners’ returns, allowing the Service to focus the administrative process on a uniform determination of the partnership items once, at the partnership level.²⁵ The procedures changed the landscape for administrative and judicial resolution of partnership issues by creating a distinct partnership-level proceeding at which all partnership items are determined. The resulting treatment would then flow to the individual partners, where issues unique to each partner would be resolved. These unified procedures were intended to eliminate the disparate treatment of partnership items in individual partner-level audits and litigation, and make the Service’s enforcement of the internal revenue laws more effective and efficient.

²¹ See A. Willis, J. Pennell & P. Postlewaite, *Partnership Taxation* at ¶ 20.01 [2] (6th ed. 1999).

²² Staff of the Joint Comm. on Taxation, 97th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* at 268 (Joint Comm. Print 1982).

²³ *Id.*

²⁴ H.R. Conf. Rep. No. 97-760, at 600 (1982).

²⁵ *Id.*; see I.R.C. § 6222.

The TEFRA Partnership Procedures created a class of tax items that are determined in the partnership-level proceeding, the effects of which pass through the Schedules K-1 to the partners. Partnership items are items that are “more appropriately determined at the partnership level than at the partner level,”²⁶ and the Regulations specifically define what items are more appropriately determined at the partnership level.²⁷ These items can include accounting practices as well as any factual or legal determinations that underlie the partnership items.²⁸ In addition, a separate rule governing the period of limitations for assessing tax attributable to partnership items was created.²⁹ Any item that is not a partnership item, or that is not treated as a partnership item, is a nonpartnership item the tax treatment of which is generally determined at the partner level under normal deficiency procedures.³⁰ Any item that is not a partnership item, but is affected by a partnership item, is an affected item that cannot be determined until the underlying partnership-level proceeding is complete.³¹

The problems associated with individual partner-by-partner administrative and judicial resolutions were also addressed in the TEFRA Partnership Procedures. Each partner whose tax liability may be affected has the ability to participate in any administrative partnership-level proceeding³² and can also seek judicial review of a Notice of Final Partnership Administrative Adjustment (“FPAA”).³³ Individual partners can also choose to settle their partnership-related tax liability with the Service, and other partners can then request consistent settlements on the same terms.³⁴ The Proposed Regulations are inconsistent with these goals. The ability of the Service to convert items on a partner-by-partner basis would signal a return to the pre-1982 regime where similarly-situated partners were treated in disparate ways. Consistent treatment of partnership items among partners would be lost as individual audits, settlements, and litigation would occur, and individual statutes of limitations would again control. The implementation of the Proposed Regulations could even increase administrative costs by giving rise to multiple proceedings concerning the same partnership items as some partners are individually audited and assessed, while others remain within the TEFRA Partnership Procedures. As in the pre-1982 environment, this would result in

²⁶ I.R.C. §§ 6221, 6231(a)(3).

²⁷ Reg. § 301.6231(a)(3)-1(a).

²⁸ Reg. § 301.6231(a)(3)-1(b). See W. McKee, W. Nelson & R. Whitmire, *Federal Tax'n of Partnerships and Partners* ¶ 10.02[3] (4th ed. 2009).

²⁹ I.R.C. § 6229.

³⁰ I.R.C. §§ 6221, 6231(a)(4). Deficiency procedures are found at sections 6211-16.

³¹ I.R.C. § 6231(a)(5); see *Maxwell v. Commissioner*, 87 T.C. 783 (1986); McKee, *supra* note 28, ¶ 10.02[5].

³² I.R.C. § 6224(a), (c).

³³ I.R.C. § 6226.

³⁴ I.R.C. § 6224(c).

simultaneous partnership-level proceedings (that would bind all unconverted partners) and individual partner-level proceedings (for each converted partner) on the same issues.³⁵

B. The Perceived Problem is not the Same as Other Special Enforcement Areas Where Treatment as Nonpartnership Items is Allowed.

The existence of specific situations where the Service is permitted to treat partnership items as nonpartnership items for one or more partners is not a new concept. Congress envisioned such situations when it enacted section 6231(c), which specifically enumerates four areas (jeopardy and termination assessments, criminal investigations, indirect methods of proof of income, and foreign partnerships) where regulatory authority was provided to treat partnership items as nonpartnership items “to the extent the Secretary determines their treatment as partnership items will interfere with the effective and efficient enforcement of the Internal Revenue laws.”³⁶ Congress also granted the Secretary the authority to promulgate regulations “necessary to achieve the purpose of the bill” where other special enforcement considerations are determined to be present.³⁷ Treasury and the Service proposed and finalized regulations under section 6231(c) in five areas where a determination was made that special enforcement considerations were present and partnership items should be treated as nonpartnership items: 1) termination and jeopardy assessments;³⁸ 2) criminal investigations;³⁹ 3) indirect methods of proof of income;⁴⁰ 4) bankruptcies and receiverships;⁴¹ and 5) prompt assessments.⁴²

The existing regulations in these five areas, however, are very different from what is contemplated in the Proposed Regulations. First, each of the current regulations focuses on the procedural status of the partner, not the substantive undertakings of the partnership. If any partner is in a procedural posture that satisfies a condition of the regulation, the partnership items are treated as nonpartnership items. This limits the

³⁵ We understand that the Proposed Regulations would also allow the Service to settle with one partner (such as a promoter) on terms that differ from other partners, effectively overriding section 6224(c).

³⁶ H.R. Conf. Rep. No. 97-760, at 610; I.R.C. § 6231(c)(1).

³⁷ H.R. Conf. Rep. No. 97-760, at 610; I.R.C. § 6231(c)(1)(E)

³⁸ Reg. § 301.6231(c)-4.

³⁹ Reg. § 301.6231(c)-5.

⁴⁰ Reg. § 301.6231(c)-6.

⁴¹ Reg. § 301.6231(c)-7.

⁴² Reg. § 301.6231(c)-8. Regulations were also proposed and finalized in two narrow areas involving section 6411 tentative carryback refunds or other certain refunds involving gross valuation overstatements or statements subject to section 6700 penalties. However, these regulations do not allow the Service to convert partnership items to nonpartnership items, they merely allow limited assessment under section 6213(b)(3) or delay the refund until after the completion of partnership proceedings, and give the partner the option of electing to treat all partnership items as nonpartnership items. Reg. §§ 301.6231(c)-1, -2.

impact of conversion to the specific partner against whom, for example, a jeopardy or termination assessment was made, or who filed for bankruptcy. In contrast, the Proposed Regulations focus on the transactions entered into by the partnership, and would allow the Service to treat partnership items as nonpartnership items at nearly any time for any or all partners. The Proposed Regulations are a departure from the existing regime as they involve a substantive, as opposed to merely procedural, determination by the Service.

Second, the current regulations state that all partnership items of a partner “shall be treated as nonpartnership items” if the conditions in the regulations are met.⁴³ This provides certainty to the taxpayer—if a partner becomes a debtor in a bankruptcy or receives a jeopardy assessment, a conversion of *all* partnership items for all partnerships will occur.⁴⁴ It also ensures that all similarly-situated partners will be treated with the same procedural due process—*any* partner in a partnership who becomes a debtor or receives a jeopardy assessment will have his partnership items converted. The Proposed Regulations offer no such assurances, as there are two stages of discretion: the Service not only unilaterally decides what transactions are listed (which could potentially be done at any point in time including during an ongoing proceeding), but after making that determination, the Service also decides whether to treat the items as nonpartnership items for each partner.

Third, the existing regulations mandating treatment of partnership items as nonpartnership items apply in narrow situations where non-conversion would clearly interfere with the effective and efficient enforcement of the tax laws. For example, when a partner files a petition and becomes a debtor in a bankruptcy proceeding, partnership items are converted to nonpartnership items to avoid a conflict between the TEFRA Partnership Procedures and certain aspects of the Bankruptcy Code, including the imposition of the automatic stay.⁴⁵ Removing the debtor-partner from the partnership-level proceeding through conversion prevents the jurisdiction or actions of the bankruptcy court from delaying or otherwise negatively affecting the TEFRA proceeding.⁴⁶ Where indirect methods of proof are used to determine taxable income or a request for a prompt assessment has been filed, there is a need to determine all sources

⁴³ Reg. §§ 301.6231(c)-4, -5, -6, -7.

⁴⁴ In the case of a criminal investigation, the regulations state that partnership items shall not be treated as nonpartnership items “unless and until” written notification from the Service is received, leaving some discretion with the Service. Reg. § 301.6231(c)-5(a). The exercise of that discretion also has been challenged. *See, e.g., Transpac Drilling Venture 1982-12 v. Commissioner*, 147 F.3d 221, 225-27 (2d Cir. 1998) (construing Temp. Reg. § 301.6231(c)-5T).

⁴⁵ Reg. § 301.6231(c)-7; *see* Fed. Tax. Coordinator ¶ T-2248.

⁴⁶ While the potential conflicts may have been reduced by amendments to the Bankruptcy Code effective Oct. 22, 1994, that provide for the issuance of deficiency notices and tax assessments against a debtor despite the automatic stay, Reg. § 301.6231(c)-7 is effective as of Oct. 4, 2001, indicating that the Service and Treasury still believe potential conflicts exist.

of income at that time without excessive delay.⁴⁷ In order to make this determination, any income attributable to partnership items must be established and adherence to the TEFRA Partnership Procedures would conflict with the timeframes required in these situations.

Cases where a criminal investigation has been initiated provide perhaps the closest parallel to the Proposed Regulations, as the Service has unilaterally made a decision that results in conversion. However, any criminal proceedings implicate constitutional protections, such as Fifth Amendment rights, that could lead to a stay of any related civil proceedings. As with a debtor-partner, the imposition of such a stay could clearly interfere with effective and efficient enforcement by causing a partnership-level proceeding to be stayed on account of a single partner on whom a criminal investigation has been initiated. Accordingly, Congress, Treasury and the Service have agreed that partners under criminal investigation will have their partnership items treated as nonpartnership items.

Unlike the existing special enforcement areas, the Proposed Regulations could allow the Service to convert for purely tactical reasons that do not rise to the level of interfering with the effective and efficient enforcement of the internal revenue laws. Whereas the policy reasons underlying conversion for the existing special enforcement areas are clear, it is less clear that the mere existence of partnership items related to a listed transaction or a transaction that is substantially similar to a listed transaction should provide the Service with the opportunity to convert items for selected partners. As discussed in Part III of these Comments, the Proposed Regulations allow conversion where enforcement has become inconvenient and even where litigation is proceeding in an unfavorable manner for the Service, including by identifying a new listed transaction. The standard for determining new special enforcement areas should continue to be whether a situation *interferes* with the effective and efficient enforcement of the tax laws exists, not merely whether enforcement has become *inconvenient*.

C. The Proposed Regulations Do Not Directly Address The Problems Described in the Preamble.

The Proposed Regulations are intended to address the increased administrative burdens caused by modern tax avoidance transactions. The preamble to the Proposed Regulations notes that recent tax avoidance transactions often use complex structures, consisting of combinations of tiered pass-through entities. These structures may therefore require multiple partnership-level proceedings to determine all partnership items and properly assess all partners. One specific example cited in the preamble involves a single individual who takes a deduction resulting from a transaction described

⁴⁷ Indirect methods of proof are used by the Service where a taxpayer's books and records are inadequate, incomplete, or do not reflect true income, and include, among others, the net worth method, the cash expenditure method, and the bank deposit method. *See, e.g.*, I.R.C. § 446(b); *Holland v. United States*, 348 U.S. 121 (1954) (net worth method); *Erickson v. Commissioner*, 937 F.2d 1548 (10th Cir. 1991) (cash expenditure method); *Guillo v. Commissioner*, 165 F.3d 915 (9th Cir. 1998) (unpublished decision) (bank deposit method).

in Notice 2000-44.⁴⁸ The preamble describes how the Service would first initiate partnership-level proceedings, and then often must issue an affected items notice of deficiency to the partner to disallow a noneconomic loss or deduction.⁴⁹ This process is characterized as “an unnecessary burden on taxpayers, the IRS, and the federal courts” where the tax liability of “only a single individual or small group of related persons” is involved.⁵⁰

However, the presence of such complexity exists completely independent from whether the partnership items in such structures are “related to” a listed transaction. The complexity of many structures involving partnerships and other pass-through entities has increased—not just those where listed transactions are involved—and the resulting increase in administrative costs and audit delays is an unfortunate but expected result. Because the Proposed Regulations would not directly address the problems identified in the preamble, and given the potential for abuse and increased costs described in greater detail below, using the listed transaction regime as the trigger for removing a specific partner from the TEFRA Partnership Procedures is an ineffective, potentially unfair and unduly burdensome solution.

Instead of reducing multiple proceedings (the stated purpose of the Proposed Regulations), a conversion by the Service of partnership items that relate to a listed transaction could have the effect of multiplying simultaneous proceedings. And while conversion may provide a tactical advantage to the Service, such advantage is not related to the “effective and efficient enforcement of the internal revenue laws.”

III. The Proposed Regulations Grant The Service Too Much Discretion.

The history behind, and the success of, the listed transaction regime informs our analysis of the Proposed Regulations and our conclusion that they create the potential for abuse of discretion or unintended burdens. Our principal concerns are:

1. The reach of the Proposed Regulations is broader than the listed transaction regime.
2. The degree of potential retroactivity embedded in the Proposed Regulations.
3. The ability of the Service to extend the statute of limitations or dictate venue through conversion of partnership items may lead to inappropriate conversion decisions.
4. The Proposed Regulations allow the Service unilaterally to strip jurisdiction from the court hearing the partnership case.

⁴⁸ Preamble to the Proposed Regulations, 74 Fed. Reg. at 7206.

⁴⁹ *Id.*

⁵⁰ *Id.*

5. The ability of the Service to unilaterally convert partnership items will be viewed by taxpayers as unfair and undermine their belief in the fairness of the tax system.

- A. Broad Reach.

The Proposed Regulations provide that the Service may opt out of TEFRA partnership proceedings if a partner has partnership items that *relate to* listed transactions or transactions substantially similar to listed transactions. The ordinary meaning of the verb “relate to”—“reference to” or “a connection with”—would arguably allow even the most tenuous link between a partnership item and a listed transaction to trigger the government’s option. Besides being overly broad and vague, the phrase “relates to” would allow for incongruous results when applied.

Take for example an intermediary transaction tax shelter, first listed in Notice 2001-16⁵¹ and clarified by Notice 2008-111.⁵² Under the Notices, an intermediary transaction is designed to avoid tax on built-in gain by interposing a tax-indifferent intermediary between a shareholder who wants to sell stock in a corporation with built-in gain, and a buyer who wants to buy the corporate assets without the built-in gain. The intermediary buys the stock, triggers the gain, and sells the assets to the buyer, all as part of one plan. In Notice 2008-111, the Service clarified that a seller, buyer, or intermediary who does not know about the plan has not participated in an intermediary transaction tax shelter.

The broad sweep of the term “related to” in the Proposed Regulations would allow the Service to convert partnership items even if the taxpayer is not treated as participating in a listed transaction. For instance, under the Proposed Regulations, a seller-partnership that negotiates an arms-length stock sale without any knowledge of the tax attributes of its intermediary-buyer (or the ultimate asset purchaser), or even that it is selling to an intermediary, and therefore has no knowledge that the transaction could be treated as a listed transaction, faces the prospect of having the partnership items that *relate to* the stock sale converted to nonpartnership items. After such a conversion, the partnership would be subject to two separate examinations by the Service because of a listed transaction that the seller-partnership did not know existed.

A better approach would be to ensure that only a partner’s *participation* in a listed transaction, within the meaning of section 1.6011-4(c)(3)(i)(A) of the Regulations, triggers the Service’s option to convert partnership items to non-partnership items. Section 1.6011-4(c)(3)(i)(A) of the Regulations provides that a taxpayer has participated in a listed transaction “if the taxpayer’s tax return reflects tax consequences or a tax strategy” of a listed transaction, if the taxpayer knows or has reason to know that tax benefits are derived directly or indirectly from a listed transaction, or if other published

⁵¹ 2001-1 C.B. 730.

⁵² 2008-51 I.R.B. 1299.

guidance treats a person as a participant in a listed transaction.⁵³ We suggest that adopting this standard would better achieve the Service’s goal of minimizing multiple proceedings with respect to partnership items.

B. Unreasonable Retroactivity.

We are also concerned about the degree of potential retroactivity embedded in the Proposed Regulations. Treasury and the Service propose to reserve to themselves maximum flexibility to list a transaction and convert partnership items long after the taxpayer has engaged in the transaction, long after the partnership has filed its tax return, and even long after the Service has begun TEFRA Partnership Proceedings against the partnership. Indeed, under the terms of the Proposed Regulations, the Service could list a transaction while it is litigating the transaction’s merits, convert the partnership items, and strip the court hearing the case of jurisdiction at any stage before the entry of final judgment. As explained in the preamble:

Under the proposed regulations, the transaction must be a listed transaction on the date the IRS sends written notification to the partner that the partner’s partnership items will be treated as nonpartnership items. Accordingly, the fact that a transaction becomes a listed transaction after the date on which the taxpayer engages in the transactions does not preclude the conversion of items under the proposed regulation. This limitation promotes taxpayer awareness of the transactions that can subject their partnership items to removal from the TEFRA partnership procedures.⁵⁴

While it is one thing to ask taxpayers to disclose transactions to the Service after the fact,⁵⁵ it is quite another to expose them to the possibility that the Service may try to change the rules and divest a court of jurisdiction or change the forum in the midst of a judicial proceeding, with little or no warning and with no published standards by which the taxpayer may assess the likelihood of such a conversion.⁵⁶

In general, retroactivity—“whether the new provision attaches new legal consequences to events completed before its enactment”—is not favored in the law.⁵⁷

⁵³ Reg. § 1.6011-4(c)(3)(i)(A).

⁵⁴ Preamble to the Proposed Regulations, 74 Fed. Reg. at 7206-07.

⁵⁵ In these Comments we do not take a position on section 1.6011-4(e)(2) of the Regulations, which asks taxpayers to disclose listed transactions to the Service even if the Service lists the transaction after the taxpayer files a return for the year, as long as the statute of limitations on assessment remains open.

⁵⁶ Courts may be reluctant to permit administrative action to divest them of jurisdiction. Unlike section 7422(e), a loss of jurisdiction through conversion pursuant to the Proposed Regulations would be driven solely by administrative action.

⁵⁷ *Landgraf v. USI Film Products*, 511 U.S. 244, 266-70 (1994) (“The principle that the legal effect of conduct should ordinarily be assessed under the law that existed when the conduct took place has timeless and universal appeal.” *Kaiser Aluminum & Chemical Corp. v. Bonjorno*, 494 U.S. 827, 855 (1990) (Scalia, J., concurring)).

An administrative rule is retroactive if it takes away or impairs vested rights acquired under existing law, creates a new obligation, imposes a new duty, or attaches a new disability to transactions or considerations already past.⁵⁸ While Treasury has limited authority to issue retroactive rules, such authority was not invoked in issuing the Proposed Regulations.

It is true that procedural changes are often applied to suits that arose before the change was enacted.⁵⁹ It is also true that jurisdiction-stripping statutes generally are given immediate effect to pending cases, because the new statute takes away the court's power to rule.⁶⁰ But the cases dealing with these concepts are distinguishable, because they deal with *general* changes to the law imposed either by the Congress or the courts. These general exceptions to the presumption against retroactivity have no bearing here, where the Service proposes to reserve to itself the right selectively, and retroactively, to change the rules governing past transactions on a case-by-case and partner-by-partner basis merely by issuing published guidance that affords no opportunity for notice or comment.

Conversion of partnership items to nonpartnership items certainly attaches new legal consequences to completed events—that is the whole point. Of course, partnerships that enter into transactions already listed by the Service would be on notice that their partnership items may be converted, so no retroactivity concern arises in those cases. By contrast, taxpayers do not have access to the standards that may cause the Service to list a transaction in the future so they cannot reasonably predict whether their partnership items may be converted to non-partnership items. The very strength of the listed transaction regime—the unbridled discretion the Service enjoys to list a transaction it considers “abusive” at any time—makes it difficult, if not impossible, to predict whether a transaction would or should be listed in the future. Indeed, the Service itself has struggled with whether particular transactions should be listed transactions.⁶¹ Even where a transaction has been identified as a listed transaction, taxpayers are left with the uncertainty of determining which transactions will be deemed by the Service to be “substantially similar” to the listed transaction.

The Proposed Regulations are very different in this regard from the existing special-enforcement conversion regulations.⁶² In general, these existing conversion events are governed by relatively objective, known standards. In contrast, the standards the Service uses to decide whether and when to list transactions are discretionary, as are the criteria used to determine whether to pursue a transaction as substantially similar to a

⁵⁸ *Nat'l Mining Ass'n v. Dep't of Labor*, 292 F.3d 849, 859 (D.C. Cir. 2002).

⁵⁹ *Landgraf*, *supra*, 511 U.S. at 275.

⁶⁰ *E.g.*, *Ex Parte McCardle*, 74 U.S. 506, 514 (1868); *see also Hallowell v. Commons*, 239 U.S. 506, 508 (1916); *but see Hamdan v. Rumsfeld*, 548 U.S. 557 (2006) (plurality opinion).

⁶¹ *See, e.g.*, Notice 2004-19, 2004-1 C.B. 606 (delisting transactions described in Part II of Notice 98-5).

⁶² *See* discussion, *supra*, in Part II.B.

listed transaction. Further, the Service also would have broad discretion to convert partnership items to non-partnership items under the Proposed Regulations. This sort of standard-less retroactivity is not favored under the law in general,⁶³ and certainly is not favored under the tax law.⁶⁴

For these reasons, if the Proposed Regulations are finalized, we recommend that the discretionary conversion be limited to listed transactions that were listed on or before the issuance of a notice of beginning of administrative proceeding or an FPAA, whichever occurs first.

C. Statute of Limitations and Venue.

One of the significant effects of a conversion of partnership items to nonpartnership items is to extend the statute of limitations on assessment with respect to the converted partnership items.⁶⁵ We do not believe the Service should have the unilateral right to extend this statutory period merely by converting at its discretion. Similarly, the Proposed Regulations would allow the Service the ability to dictate venue. For example, if the partner's residence is different from the partnership's principal place of business, converting the partnership items to nonpartnership items would cause the case to be litigated in a different federal district court or, pursuant to the *Golsen* rule, under different Circuit law in the Tax Court.

For these reasons, if regulations allowing conversion of partnership items to nonpartnership items are finalized, we urge Treasury to reserve that extraordinary authority to the highest levels of management within the Service, requiring authorization from the National Office. This will better insulate revenue agents and taxpayers from the risk that conversions would be made for improper statute-preserving purposes or for tactical forum-shopping purposes, instead of the stated purposes set forth in the preamble.

D. Jurisdiction-Stripping Effect.

Another concern raised by the Proposed Regulations is whether an agency-party to litigation can itself exercise the unilateral power to strip jurisdiction from the court hearing the case. Of course, as discussed earlier, Congress may pass general jurisdiction-stripping statutes that are generally given immediate effect in all pending cases,⁶⁶ but the Proposed Regulations present an entirely different situation. Treasury and the Service

⁶³ See *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 220 (1988) (Scalia, J. concurring).

⁶⁴ See Staff of the Joint Comm. on Taxation, 104th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in the 104th Congress at 44 (Joint Comm. Print 1996) ("The Congress believed that it is generally inappropriate for Treasury to issue retroactive regulations").

⁶⁵ I.R.C. § 6229(f)(1).

⁶⁶ E.g., *Bruner v. United States*, 343 U.S. 112 (1952); *Hallowell v. Commons*, 239 U.S. 506 (1916) (affirming dismissal after Congress passed statute stripping jurisdiction and effectively transferring the dispute to an administrative agency); but see *Hamdan v. Rumsfeld*, 548 U.S. 557, 576 (2006) (plurality opinion).

purport to reserve the unilateral right to remove jurisdiction from a court presiding over a TEFRA partnership proceeding at any time up until the entry of a final decision or judgment. In these limited Comments, we do not offer our views as to whether such an attempt would be valid or permissible. We merely suggest that, if the Proposed Regulations are finalized, Treasury and the Service should limit the government's ability to convert to the time prior to the issuance of an FPAA.

IV. The Proposed Regulations Create Additional Problems.

Implementation of the Proposed Regulations would also expose the Service to further delay, expense, and potentially even additional litigation. Under the Proposed Regulations, the Service will be allowed to unilaterally convert partnership items based on a determination that the partnership items are related to a listed transaction or a substantially similar transaction. This determination can occur at nearly any time in the TEFRA partnership proceeding, including after judicial proceedings have commenced or just before the expiration of the partnership statute of limitations. If the Service makes such a determination, new litigation issues likely will arise. For example, if the Service converted the partnership items and issued a notice of deficiency, the notice could later be found invalid if the transaction in question was determined not to be a listed transaction, or substantially similar to a listed transaction. In this situation, it is possible that the partnership statute of limitations will have expired and an FPAA could no longer be issued.