

[ N(35)000-152 ]

March 2, 1998

Taxpayer Relief Act of 1997 -

**Subject:** Amendments to TEFRA Provisions **Cancellation Date:** Aug. 29, 1998

The purpose of this Notice is to summarize the changes made by the Taxpayer Relief Act of 1997 (TRA 1997), Pub. L. No. 105-34, 111 Stat. 788 (1997), that affect the unified partnership audit and litigation procedures of I.R.C. §§ 6221-6245, commonly referred to as the "TEFRA" partnership provisions. The changes are summarized below according to whether their effect is retroactive or prospective.

### RETROACTIVE CHANGES

The following changes are effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

#### Special Proceeding to Determine Innocent Spouse Status (TRA Sec. 1237; I.R.C. § 6230)

TRA 1997 amended section 6230 to provide that a partner's spouse may request abatement 60 days from the mailing of a notice of computational adjustment (*i.e.*, a notice of liability resulting from a TEFRA proceeding) based on the grounds that he or she is entitled to innocent spouse status under I.R.C. § 6013(e). If a timely request is made, the Service must abate the assessment. The Service must issue a special notice of deficiency within 60 days of the abatement in order to reassess. The period for assessment is suspended during this 60 day period. Tax Court jurisdiction conferred by a petition to such notice is limited to the innocent spouse defense and may not be used to contest the underlying merits of the partnership or penalty adjustments.

Alternatively, the spouse alleging application of section 6013(e) may sue for refund under section 6230(c)(5), if a refund claim is filed within six months of the notice of computational adjustment.

This amendment is retroactive to the date of enactment of TEFRA (September 3, 1982). (We note that this provision may be

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superseded by a provision contained in proposed legislation. Section 321 of the Internal Revenue Service Restructuring and Reform Act proposes a new procedure for spouses claiming application of I.R.C. § 6013(e), which would apply to both TEFRA and non-TEFRA assessments.)

Extension of the TEFRA Period for Assessment Extends the Period for Filing Administrative Adjustment Requests (TRA Sec. 1236, 1243; I.R.C. § 6227)

TRA 1997 amended section 6227 to provide that an extension of the TEFRA period for assessment under section 6229(b) by the tax matters partner on behalf of all partners, and an extension of this period by a partner on his own behalf, extends, respectively, the period for filing partnership level and partner level Administrative Adjustment Requests ("AARs") (the TEFRA equivalent of a refund claim) under section 6227. Also, a seven year limitations period now applies to the filing of AARs for bad debts or worthless securities, instead of the three year period provided for under prior law.

This amendment is retroactive to the date of enactment of TEFRA (September 3, 1982).

Appellate Bond Computation (TRA Sec. 1241; I.R.C. § 7485)

TRA 1997 amended section 7485(b) to clarify that a bond filed to stay assessment upon appeal is limited to the amount of the aggregate tax liability (including penalties and interest) of partners who remain "parties" to the litigation at the time of appeal. All partners are deemed "parties" to a partnership appeal except for those partners whose partnership items have converted to nonpartnership items or whose period for assessment has expired. I.R.C. § 6226(c) and (d). The legislative history of this provision explains that the amount of the bond may be estimated by applying the highest individual rate to the adjustments determined by the Tax Court (reduced by the portion allocable to partners who are no longer "parties") and doubling that amount to take into account related penalties and interest.

This amendment is retroactive to the date of enactment of TEFRA (September 3, 1982).

**PROSPECTIVE CHANGES**

The following changes are effective for taxable years ending after August 5, 1997, or for specified actions occurring after August 5, 1997.

Declaratory Judgment Action for Oversheltered Nonpartnership Items  
(TRA Sec. 1231; I.R.C. § 6234)

TRA 1997 added new section 6234, which permits a declaratory judgment action for nonpartnership items oversheltered by partnership deductions. Specifically, the procedure applies when a return shows no taxable income and a net loss from partnership items, and, as a consequence, no deficiency in tax arises from an adjustment to nonpartnership items. Accordingly, the Service may issue a "notice of adjustment" which adjusts nonpartnership items. If a TEFRA partnership proceeding subsequently causes the nonpartnership adjustments to result in tax, the tax attributable to the nonpartnership adjustments may be assessed as part of the computational adjustment of partnership items.

The notice of adjustment is treated similarly to a notice of deficiency for purposes of the petition period, statute of limitations suspension, restrictions on issuing a second notice, etc. An adjustment notice that results in a deficiency in tax (as a result of a final determination of any partnership item for the taxable year) is automatically deemed to be a valid notice of deficiency. Similarly, a notice of deficiency that results in no deficiency in tax will automatically be deemed to be a proper notice of adjustment if the notice otherwise meets the criteria of section 6234.

This amendment applies to partnership taxable years ending after August 5, 1997.

Expansion of Small Partnership Exception to TEFRA (TRA Sec. 1232;  
I.R.C. § 6231)

Under prior law, section 6231(a)(1)(B) provided for a small partnership exception to TEFRA when the partnership had 10 or fewer natural persons as partners, none of whom were nonresident aliens, and there were no special allocations resulting in a violation of a "same share" requirement. TRA 1997 amended section 6231 to provide that the small partnership exception to TEFRA includes partnerships with C corporation partners and special allocations. Flow through entities and nonresident alien partners will continue to make the small partnership exception to TEFRA inapplicable.

This amendment applies to partnership taxable years ending after August 5, 1997.

Reliance on Partnership Return to Determine if TEFRA Applies (TRA Sec. 1232; I.R.C. § 6231)

TRA 1997 amended section 6231 to provide that the Service may "reasonably" rely on the partnership return to determine whether or not a partnership is subject to the TEFRA procedures. Due to concurrent amendments to the exception from TEFRA for certain small partnerships, this provision potentially is only applicable to identifying the number and type of partners in the partnership. A partnership is excepted from the TEFRA provisions if it has no more than 10 partners at any time during the taxable year, all of whom are natural persons (other than nonresident aliens) or C corporations. Flow through entities as partners continue to make the small partnership exception inapplicable. Significant questions remain as to what type of reliance would be "reasonable." For instance, the partnership return may reflect 12 partners, when there were never more than 10 partners (because 2 partners sold their interest to new partners during the taxable year). Similarly, the identity of a partner as a corporation does not necessarily mean that it is a C corporation, as it may be an S corporation or Limited Liability Company.

This amendment applies to partnership taxable years ending after August 5, 1997.

Untimely Partnership Petitions Suspend the Period for Assessment (TRA Sec. 1233; I.R.C. § 6229)

TRA 1997 amended section 6229(d) to provide that untimely partnership petitions suspend the period for assessment. Prior to this amendment, a petition filed after the petition period expired did not suspend the period for assessment. The amendment to this section conforms the TEFRA rule to the non-TEFRA rule as set forth in section 6503(a).

This amendment applies to partnership taxable years for which the period under section 6229 has not expired as of August 5, 1997.

Effect of Bankruptcy Proceeding on Period for Assessment (TRA Sec. 1233; I.R.C. § 6229)

TRA 1997 amended section 6229(h) to provide that the section 6229 period for assessment against a partner is suspended during the pendency of the automatic stay of assessment in the partner's bankruptcy proceeding. Note, however, that the Bankruptcy Reform Act of 1994 amended Section 362(b)(9)(D) of the Bankruptcy Code to provide that the automatic stay under Section 362(a) of the Bankruptcy Code is not a bar to the making of an assessment for any tax. Thus, new section 6229(h) has no effect.

This amendment applies to partnership taxable years for which the period under section 6229 has not expired as of August 5, 1997.

Bankrupt TMP May Continue Extending Period for Assessment (TRA Sec. 1233; I.R.C. § 6229)

TRA 1997 amended section 6229(b)(2) to provide that, notwithstanding any other law or rule of law, if an agreement is entered into under subsection 6229(b)(1)(B) to extend the period for assessing partnership items, and the agreement is signed by a person who would be the tax matters partner (TMP) but for the fact that, at the time the agreement is executed, the person is named as a debtor in a bankruptcy proceeding, such agreement shall be binding on all partners unless the Service has been notified of the bankruptcy in accordance with the regulations.

This provision is intended to protect the Service because bankruptcy terminates a partner's status as TMP. Thus the TMP would have no authority to extend the period for assessment. See Temp. Treas. Reg. § 301.6231(c)-7T (bankruptcy conversion); Treas Reg. § 301.6231(a)(7)-1(l)(1)(iv)(termination as TMP); I.R.C. § 6229(b)(TMP authorized to extend period for assessment). The new subsection continues the bankrupt partner's authority to extend the period for assessment on behalf of all partners, notwithstanding the bankruptcy, until the Service is formally notified of the bankruptcy in a manner to be prescribed by regulations. Once informed of the partner's bankruptcy in accordance with such regulations, the Service's reliance on the partner's authority as TMP to extend the period for assessing partnership items is terminated.

This amendment applies to agreements entered into after August 5, 1997.

Partial Settlements Do Not Start Period for Assessment (TRA Sec. 1235; I.R.C. § 6229)

TRA 1997 amended section 6229(f)(2) to provide that the period for assessing partial settlements is treated as if the agreement was not entered into, i.e., the period for assessment is governed by the period for assessing the remaining partnership items.

Settlement agreements convert the settled items to nonpartnership items (I.R.C. § 6231(b)(1)(C)) and initiate a one year period for assessment (I.R.C. § 6229(f)). Thus, prior to this amendment, if the Service executed a partial settlement, the Service would have to track two separate periods for assessing partnership items and make two separate assessments. The change to section 6229(f) allows the Service to track only one period for assessment and make only one assessment.

This amendment applies to settlements entered into after August 5, 1997.

Penalties Determined at the Partnership Level Except for Partner Level Defenses (TRA Sec. 1238; I.R.C. § 6221)

TRA 1997 amended section 6221 to provide that penalties, additions to tax, and additional amounts are to be determined at the partnership level (and immediately assessed following the completion of the proceeding). Partner level defenses may be asserted only through refund actions. I.R.C. § 6230(c)(4). A conforming amendment has been made to section 6230(a)(2)(A)(i) (deficiency procedures now inapplicable to determine penalties, additions to tax and additional amounts that relate to partnership items).

For taxable years ending prior to the effective date of this change, the Service will continue to issue "affected item notices of deficiency" following the completion of a partnership proceeding to each separate partner to determine penalties and additions to tax.

This amendment applies to partnership taxable years ending after August 5, 1997.

Tax Court May Enjoin Premature Assessment and Collection of Partnership Items (TRA Sec. 1239; I.R.C. § 6225)

TRA 1997 amended section 6225(b) to provide that the Tax Court may enjoin premature assessments relating to partnership level proceedings. The court's jurisdiction is limited to properly petitioned FPAA's and does not extend to adjustments that are not subject to such petitions.

This amendment applies to partnership taxable years ending after August 5, 1997.

Affected Items Are Subject to Non-TEFRA Refund Procedures (TRA Sec. 1239; I.R.C. § 6230)

TRA 1997 amended section 6230(d)(6) to provide that affected items are subject to regular (non-TEFRA) refund procedures. See Woody v. Commissioner, 95 T.C. 193 (1990). Section 6230(d)(6) previously provided that the non-TEFRA refund procedures of Subchapter B of Chapter 66 did not apply to partnership items or affected items.

The change only involves "affected items" requiring partner level determinations. Partnership items and purely computational issues remain exclusively under the TEFRA provisions. Cf. N.C.F. Energy Partners v. Commissioner, 89 T.C. 741 (1987)(discussing distinction between computational items which are subject exclusively to TEFRA partnership procedures and noncomputational affected items subject to separate deficiency procedures).

This amendment applies to partnership taxable years ending after August 5, 1997.

Tax Court Overpayment Jurisdiction in a Deficiency Proceeding Expanded to Include Affected Items Asserted Within the TEFRA Partnership Period for Assessment or Refund (TRA Sec. 1239; I.R.C. § 6512)

TRA 1997 amended section 6512(b)(3) to substitute the TEFRA periods of limitation under sections 6229 and 6230(d) for the periods under sections 6511(b)(2), (c) and (d), for raising overpayments attributable to affected items in deficiency proceedings. Affected items may not generally be considered in a deficiency proceeding prior to the completion of the partnership proceeding. See N.C.F. Energy Partners v. Commissioner, 89 T.C. 741, 743 (1987). This amendment grants partners the benefit of extending TEFRA periods to raise overpayments attributable to affected items in deficiency proceedings.

This amendment applies to partnership taxable years ending after August 5, 1997.

Premature Petitions Deemed Valid (TRA Sec. 1240; I.R.C. § 6226)

TRA 1997 amended section 6226 to provide that a notice partner (or 5% group) petition filed in the first 90 days after an FPAA is issued (the period reserved for tax matters partner petitions) is deemed filed on the last day of the following 60 day period (the period during which a notice partner may file a petition), if no other valid petition is filed.

Frequently confusion arises as to whether a petition filed in the first 90 days after an FPAA is issued is filed by the tax matters partner (TMP) for the partnership. Determinations that the petitioner was not the TMP led to litigation over jurisdiction. Since an invalid TMP petition may now be deemed to be a valid notice partner petition on behalf of the partnership, future litigation concerning jurisdiction under these circumstances should be avoided.

This amendment applies to petitions filed after August 5, 1997.

Suspension of Interest (TRA Sec. 1242; I.R.C. § 6601)

TRA 1997 amended section 6601(c) to provide that interest is suspended on a computational adjustment relating to a TEFRA settlement, where the Service does not issue notice and demand for payment within 30 days of the settlement. This conforms the TEFRA rule to the rule applicable to non-TEFRA assessments where the taxpayer has waived the restrictions on assessment and collection.

This amendment applies to adjustments with respect to partnership taxable years beginning after August 5, 1997.

Please refer any questions on the above changes to the Field Service Division, Passthroughs and Special Industries Branch at (202) 622-7830.

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