



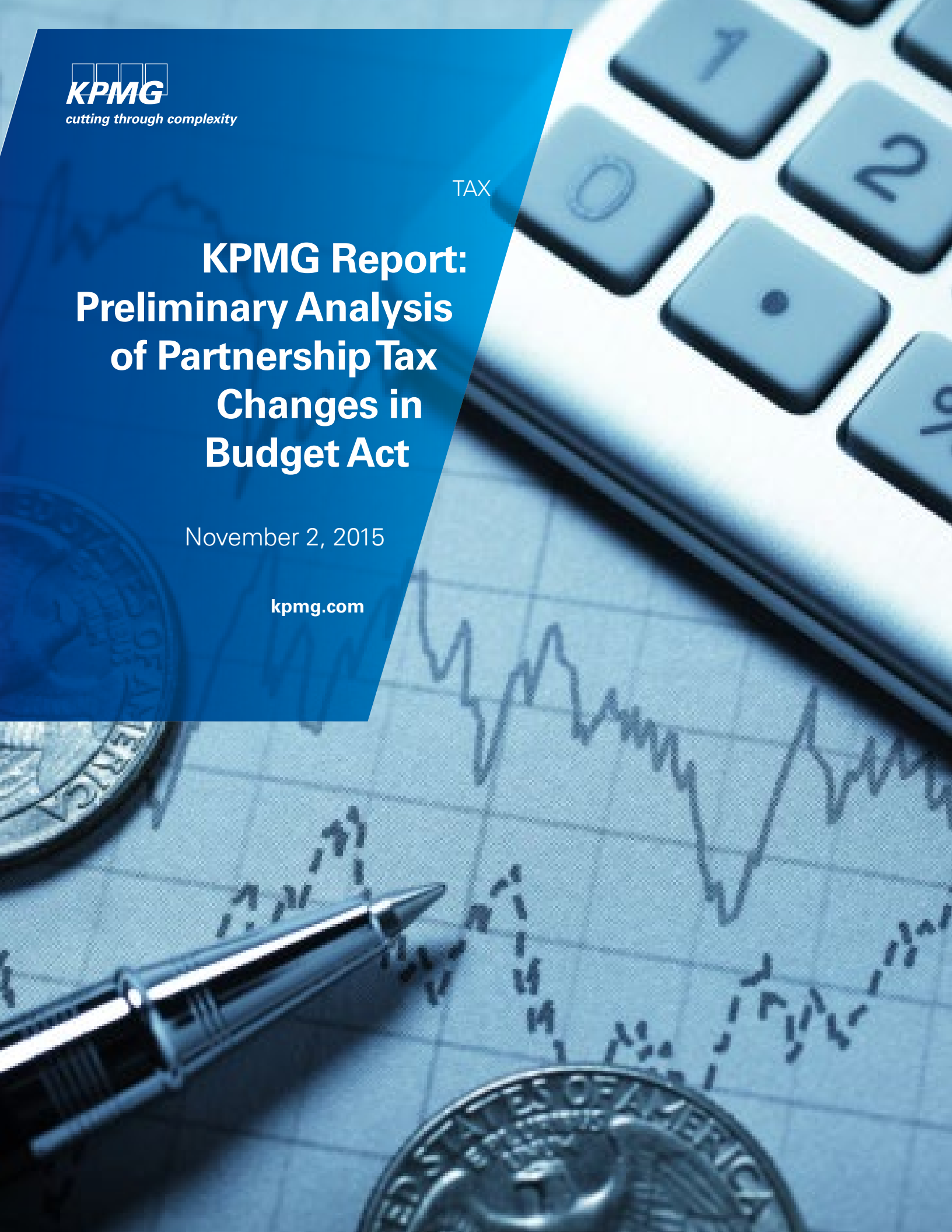
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TAX

KPMG Report: Preliminary Analysis of Partnership Tax Changes in Budget Act

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President Obama on November 2, 2015, signed into law H.R. 1314, the Bipartisan Budget Act of 2015 (the “Budget Act”). The Budget Act includes two provisions relating to the taxation of partnerships and their partners:

- New rules for partnership audits and adjustments, and
- Amendments to Code sections 704(e) and 761(b) relating to the determination of who is a partner in a partnership.

This report summarizes, and makes initial observations about, the newly enacted partnership tax law changes based on a preliminary assessment of the Budget Act’s provisions.

DOCUMENTS

Read the [statutory language](#) [PDF 290 KB] of the Budget Act, a section-by-section [summary](#) [PDF 152 KB] of its provisions, and a [revenue table](#) showing the estimated revenue effects of the tax provisions. The revenue table shows that the new rules for partnership audits and adjustments would raise approximately \$9.325 billion over the 10-year budget period, while the amendments to Code sections 704(e) and 761(b) would raise approximately \$1.894 billion over that period.

RULES FOR PARTNERSHIP AUDITS AND ADJUSTMENTS

Generally effective for returns filed for partnership tax years beginning after 2017, the Budget Act repeals the unified audit rules established by the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”) and the special rules for electing large partnerships (“ELPs”) and replaces them with a single system of centralized audit, adjustment, and collection of tax for *all* partnerships, except for certain eligible partnerships that affirmatively elect out of the regime for a tax year. Specifically, for future returns to which the Budget Act applies, the currently applicable Code sections 6221 through 6255 and sections 771 through 777 are repealed and replaced with new Code sections.

As explained below, the new regime generally provides for assessment and collection of underpaid tax at the *partnership* level. Thus, even though partnerships are “flowthrough entities,” they could be subject to entity-level tax. However, the Budget Act also provides an elective mechanism by which a partnership could push out the payment of underpaid amounts in the current year to those who were partners in the year to which the adjustment relates.

KPMG Observation. The Budget Act makes substantial changes to the manner in which partnerships are audited and taxes are assessed and collected. We anticipate that these changes will require most partnerships to consider the impact of the new law on their agreements and transactions. In addition, the new law will need to be taken into account in connection with partnership due diligence.

Background

In recent years, there has been increased focus on problems the IRS faces in auditing large partnerships. For example, in July 2014, the U.S. Government Accountability Office (GAO) provided [testimony](#) [PDF 412 KB] before the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs assessing the IRS's ability to audit "large" partnerships (defined for this purpose as partnerships with \$100 million or more in assets and 100 or more direct and indirect partners). The GAO testified, among other things, that although the number of large partnerships more than tripled from tax years 2002 to 2011, the IRS audits few large partnerships. The GAO noted that, in 2012, the IRS audited only 0.8% of large partnerships, compared to 27.1% for large corporations.

A few months later, the GAO issued a [report](#) recommending that Congress consider legislation requiring a large partnership to identify a partner to represent it during audits and to pay taxes on audit adjustments at the *partnership* level. The report's findings included that:

- The IRS audits few large partnerships, most audits result in no change to the partnership's return, and the aggregate changes are small.
- These audit results may be due to challenges—such as finding the sources of income within multiple tiers while also complying with TEFRA within specified timeframes. For example, the IRS auditors said that it can sometimes take months to identify the partner that represents the partnership in the audit, reducing time available to conduct the audit.
- Under TEFRA, unless the partnership elects to be taxed at the entity level (which few do), the IRS must pass any audit adjustments through to the ultimate partners. The process of determining each partner's share of the adjustment is paper and labor intensive, according to the IRS. When hundreds of partners' returns have to be adjusted, the costs involved limit the number of audits the IRS can conduct.

- According to the GAO, adjusting the partnership return instead of the partners' returns would reduce these costs but, without legislative action, the IRS's ability to do so is limited.

Subsequently, several similar legislative proposals were introduced to reform the partnership audit rules by, among other things, imposing a partnership-level tax in the case of audit adjustments. Prior to the Budget Act, the most recent of these proposals was H.R. 2821, the Partnership Audit Simplification Act, introduced by two members of the House Ways and Means Committee, Rep. Renacci (R-OH) and Rep. Kind (D-WI).

A number of groups, however, raised concerns about aspects of H.R. 2821, including that it would have applied to more than the kinds of "large" partnerships addressed by GAO reports and would have imposed *joint and several liability* for the assessment of underpaid tax on the partnership and all its direct and indirect partners in both the year to which the adjustment relates and the year in which the adjustment finally is determined. H.R. 2821 also generally would have required past-year partners to file amended returns in many situations for the amount of the assessment to reflect the character of the income underpaid and the characteristics of the partners.

Congressional leadership and the White House in late October 2015 decided to include partnership audit reform in the Budget Act. They seemingly based the Budget Act partnership audit provisions on H.R. 2821, but made some significant changes. The modified version of the statutory language had not previously been made public.

KPMG Observation. As a general matter, the modifications relative to H.R. 2821 address some of the concerns that had been raised regarding that previous proposal. For example, the Budget Act's partnership audit regime:

- Allows relatively more partnerships to elect out of the new regime,
- Does not include the "joint and several" liability provision from H.R. 2821,
- Allows the amount of an underpayment to be adjusted to better reflect the particular facts without requiring amended returns, and
- Provides an elective mechanism by which those who were partners in the year to which the adjustment relates (rather than the partnership) can be responsible for payment of underpaid amounts in the current year.

Nonetheless, given that the modified version of the statutory language had not previously been made public, it can be expected that there will a number of questions raised about the new rules. Fortunately, the delayed effective date (generally, returns filed for partnership tax years beginning after 2017) provides

time for issues to be identified and for the IRS, the Treasury Department, and possibly even Congress to provide needed guidance and clarification. Also, it is not yet clear how state and local taxing authorities will respond to this new regime.

Partnerships to Which New Regime Applies

The new audit and adjustment regime applies to *all* partnerships, except for certain qualifying partnerships that affirmatively elect out for a tax year. A partnership can elect out of the new regime for a tax year only if:

- It is required to furnish 100 or fewer statements under section 6031(b) (i.e., Schedules K-1) with respect to its partners for the tax year;
- Each of its partners is an individual, a decedent's estate, a C corporation, an S corporation, or a foreign entity that would be treated as a C corporation if it were domestic; and
- Certain procedural requirements are met relating to the election.

Certain special rules, however, must be followed for a partnership with an S corporation partner to elect out of the regime. For example, the partnership generally must provide the IRS with the names and taxpayer identification numbers of the S corporation's shareholders (in accordance with procedures prescribed by Treasury). If the partnership has an S corporation partner, then the Schedules K-1 furnished by the S corporation are treated as statements of the partnership for purposes of the "100 or fewer" rule.

In addition, Treasury can issue rules similar to those applicable to S corporation partners to other kinds of partners.

KPMG Observation. Several observations are worth noting with respect to the eligibility to elect out of the new regime.

- The universe of partnerships eligible to elect out of the new regime is larger than it would have been under H.R. 2821. For example, the Budget Act provisions look to the number of Schedules K-1 required to be furnished by a partnership in determining whether a partnership meets the "100 or fewer" requirement, whereas H.R. 2821 looked to the number of direct and indirect partners in the partnership. In addition, H.R. 2821 did not allow a partnership with an S corporation partner to elect out and specifically provided that C corporation partners did not include real estate investment trusts (REITs) or

regulated investment companies (RICs). The new law omits the specific reference to REITs and RICs, suggesting that the presence of REIT or RIC partners by itself will not cause the new regime to apply to a partnership that is required to furnish 100 or fewer Schedules K-1. Further, unlike H.R. 2821, the Budget Act provides Treasury with broad authority to allow partnerships that are required to furnish 100 or fewer Schedules K-1 to elect out regardless of what kinds of partners they have, as long as the partnership is able to disclose information about the owners of those partners (under rules similar to those applicable to S corporation partners).

- Pending administrative guidance, partnerships that are required to furnish more than 100 statements, or those that have a partnership or trust as a partner, may not elect out of the new regime. Partnerships that have tax-exempt partners will need to determine the entity classification of each tax-exempt partner as some tax-exempt entities can be formed as either trusts or C corporations.
- Note that the “100 or fewer” requirement is based on the requirement to furnish Schedules K-1, and seemingly not the number actually furnished. Nevertheless, partnerships that routinely provide a separate Schedule K-1 for each class of interest one partner may hold may want to revisit the potential implications of issuing the additional Schedules K-1 on whether that partnership is eligible to elect out. It is also worth noting that, to the extent that there are multiple transfers of the same interest during the tax year, it appears that each transfer generally will be taken into account for purposes of the “100 or fewer” requirement.
- To elect out, a partnership will need to consider whether any partners that are foreign entities would be treated as C corporations if domestic. Under the entity classification rules, the only domestic eligible entities that are classified as corporations for federal tax purposes are those that are either *per se* (such as incorporated entities or certain special taxpayers such as insurance companies and REITs) or those that elect to be classified as a corporation. Thus, it is unclear what is intended by referencing foreign entities that would be treated as C corporations if domestic.
- The current rules do not specifically address how a partnership interest that is owned by an entity that is disregarded as an entity separate from its owner will be treated. In general, such an entity is disregarded, and its activities are treated in the same manner as a sole proprietorship, branch or division of the owner, for federal income tax purposes. Accordingly, the fact a disregarded entity owned by an individual or a C corporation holds a partnership interest seemingly should not disqualify the partnership from electing out of the new regime. However, note that in Rev. Rul. 2004-88, the IRS concluded that the disregarded entity itself, and not its owner, was treated as the owner of a partnership interest for purposes of the small partnership exception from

TEFRA and that such exception, therefore, was not applicable. Thus, query what Congress intended with regard to the treatment of disregarded entities.

- Note also that many partnership interests are owned by nominees and individual retirement accounts (IRAs). These ownership arrangements also may raise issues regarding eligibility to elect out, at least pending administrative guidance.

Considerations Regarding Electing Out of the Regime

In order to elect out of the new regime, an eligible partnership must file an election with its timely filed return for each year for which the election would apply, plus must disclose the name and taxpayer identification number of each partner in the partnership (unless the Treasury provides alternative identification for foreign partners). The partnership also must notify each partner of the election.

KPMG Observation. Partnerships that are eligible to elect out of the new regime will need to consider whether they want to elect out; an affirmative election will need to be made for each tax year that the partnership wants to elect out. Because the election is made with respect to a tax year, it appears that an eligible partnership could elect out of the regime for some years, but not for others.

In considering whether to elect out, keep in mind that, if a partnership elects out, the general “non-TEFRA” assessment and collection rules that were not modified by the Budget Act would apply. Thus, the IRS could still audit the partnership at the partnership level, but the partnership could not extend the statute of limitations for assessment for partnership items for the partners. Instead, each partner’s period for assessment for partnership items would correspond to the partner’s limitation period for other items under section 6501, and the IRS would need to enter into a separate agreement to extend the period with each partner. Similarly, the partnership could not settle partnership items on behalf of the partners. Instead, the IRS would need to enter into a separate settlement with each partner. For partners that do not resolve their partnership issues with the IRS, the IRS would have to issue each partner a statutory notice of deficiency within the partner’s limitation period under section 6501. Each partner would have an option to petition the deficiency to the U.S. Tax Court or to pay the deficiency and seek a refund in the appropriate federal district court for that partner or the U.S. Court of Federal Claims. Thus, more than one case on the same issue or issues from the partnership could occur at the same time.

Also note that a partnership that is otherwise eligible to elect out should consider the possible implication to the “reviewed year” partners versus current year partners if a potential examination might not result in an imputed underpayment (e.g., if there is a net increase in deductions or losses); under the new audit regime, these items are taken into account by the partnership in the current year. The partnership’s ability to elect the alternative method, described below, to push back the payment of underpaid amounts to those who were partners in the year to which the adjustment relates appears limited to items that result in an “imputed underpayment.” Accordingly, any partnership that has not elected out of the new regime, and is eligible to, may be prohibited from sending any adjustment items related to net losses or net deductions back to the partners who were in the partnership during the reviewed year.

Adjustments and Collections

Very generally, if the new audit regime applies, the IRS will audit items of income, gain, loss, deduction, or credit of the partnership (and any partner’s distributive share thereof) at the partnership level. The IRS likewise will assess and collect any taxes, interest, or penalties relating to an adjustment at the partnership level. However, as explained below, a mechanism is provided pursuant to which those who were partners in the year that is the subject of the adjustment can pay their shares of the adjustment (instead of the partnership), as a result of a Schedule K-1 approach that does not involve the partners amending past year returns.

General Approach to Adjustments

Subject to special rules described below, if the IRS determines that adjustments are required for the partnership tax year being audited (the “reviewed year”), the partnership is required to pay any “imputed underpayment” with respect to the adjustment in the year in which the adjustment is finalized (the “adjustment year”). An adjustment that does **not** result in an imputed underpayment generally is taken into account by the partnership in the adjustment year as a reduction in non-separately stated income or an increase in non-separately stated loss (or, in the case of a credit, as a separately stated item).

KPMG Observation. The treatment of an item as non-separately stated seemingly would generally result in ordinary treatment. Section 702(a)(8) is a catch-all provision that includes all partnership items that are not specifically

required to be separately stated under section 702(a) or that are required to be separately stated by regulations. Section 702(a)(8) taxable income or loss is typically considered to be ordinary income or ordinary loss.

Amount of Imputed Underpayment

In the case of an underpayment, the imputed underpayment generally is determined by (1) netting adjustments of items of income, gain, loss, or deduction for the reviewed year, and (2) multiplying this net amount by the “highest rate of tax in effect for the reviewed year under section 1 or 11” (i.e., the highest individual or corporate rate). Thus, under the current rate structure, the 39.6% individual rate appears to be the “default” rate used for computing the imputed underpayment (even if there are C corporation partners).

Importantly, however, the Budget Act allows Treasury to establish procedures under which the imputed underpayment amount can be modified to better reflect the amount properly owed to the government based on the character of underpaid income and the nature of the partners. More specifically, the Budget Act directs the IRS to establish procedures that “shall” provide for:

- Adjusting the amount of the underpayment to reflect amended returns filed by one or more partners for the tax year of such partners that includes the end of the partnership’s reviewed year.
- Determining the amount of the imputed underpayment without regard to the portion thereof that the partnership demonstrates is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity (as defined in Code section 168(h)(2)).
- Taking into account a rate of tax lower than the highest rate in effect under Code section 1 or 11 with respect to any portion of the imputed underpayment that the partnership demonstrates is allocable to a C corporation partner (in the case of ordinary income) or to an individual or S corporation (in the case of capital gain or a qualified dividend). If a portion of an imputed underpayment is subject to a lower rate, the portion is determined by reference to the partners’ distributive share of items to which the imputed underpayment relates. If it is attributable to more than one item, and any partner’s share of such items is not the same with respect to all such items, then the portion of the imputed underpayment to which the lower rate applies is determined by reference to the amount which would have been the partner’s distributive share of net gain or loss if the partnership had sold all of its assets at their fair market value as of the close of the reviewed year.

In addition, the Budget Act provides Treasury with authority to provide for additional procedures for modifying the amount of the imputed underpayment based on other factors, as appropriate.

KPMG Observation. Although the initial determination of the imputed underpayment does not take into account the character of the income or the nature of the partners, the Budget Act at least provides ways for the amount to be reduced to better reflect the actual amount owed the government based on the particular facts, and explicitly directs the IRS to provide guidance with regard to tax-exempt shareholders and certain capital gains income. Moreover, the adjustment mechanisms reflect an improvement over those set forth in H.R. 2821, which suggested that partners would have to file amended returns for the reviewed years for the imputed overpayment amount to be reduced, even in cases involving tax-exempt partners or capital gain income.

Nonetheless, several issues arise with respect to the provisions relating to reducing the amount of the imputed underpayment. For example:

- It is not clear why (under the current rate structure) the Budget Act suggests that an imputed underpayment would be determined using a 35% rate (rather than a 39.6% rate) in the case of a C corporation only in the case of ordinary income. Seemingly, an adjustment with regard to capital gain of a C corporation partner likewise should be subject to tax at no more than a 35% rate.
- Although the use of a “fair market value” sale approach in the rule with respect to varied treatment of items among partners may have been an effort to provide a simplifying assumption, it may cause additional burdens by requiring a determination of fair market value.
- No provision is made to take into account tax attributes of the partners such as net operating losses (NOLs) or lower, treaty-based, rates that may be applicable for certain foreign partners.
- Note also that the modification of the underpayment amount to reflect items that were included on the amended return of the partners for the reviewed year is limited if the adjustment is one that reallocates the distributive share of any item from one partner to another. In this case, the adjustment to the partnership’s underpayment amount to reflect items for which a partner filed an amended return is restricted to only those items for which all affected partners file amended returns.

Payment of Imputed Underpayment by Partnership

As a general matter, the Budget Act requires a partnership to pay the imputed underpayment with respect to the adjustment by the due date of the partnership's tax return (without regard to extensions of time to file) for the year for which the adjustment is finally determined (i.e., the adjustment year). Further, no deduction is allowed under the income tax title of the Code for any payment required to be made by the partnership.

KPMG Observation. Even though a C corporation can deduct interest payments, a partnership apparently would not be able to deduct even the interest with respect to an imputed underpayment. Although it is not clear, presumably the non-deductible payment by the partnership of an imputed underpayment would reduce the partner's tax basis in its partnership interest and the partner's tax basis would be increased to reflect the partner's share of the IRS's adjustment to partnership income.

Alternative Mechanism for Payment by Partners

Payment of the imputed underpayment by the partnership puts the economic burden of underpaid tax with respect to a past year on the current partners of the partnership. The Budget Act provides an elective alternative mechanism that puts the burden on the partners in the reviewed year.

Specifically, a partnership that receives a notice of final partnership adjustment can elect to furnish to each partner in the *reviewed year* a statement of the partner's share of the adjustment. In such case, each partner's tax imposed by Chapter 1 of the Code (i.e., Code sections 1 through 1400) for the tax year that includes the date the statement is furnished (i.e., the current tax year) is increased to reflect the adjustment amount, as well as any associated penalties or interest. The general rate of interest on underpayments is determined by adding three percentage points to the federal short-term rate. Significantly, however, under the new law, interest is determined by adding five percentage points, rather than three percentage points, to the federal short-term rate. Thus, there appears to be an interest "toll charge" to having the reviewed-year partners, rather than the partnership, pay the imputed underpayment. In addition, any subsequent year tax attribute that would have been affected if the adjustment had been taken into account in the reviewed year is "appropriately adjusted."

In order to apply this alternative collection regime, the partnership will have to make an election no later than 45 days after the date of the notice of final partnership adjustment.

KPMG Observation. The elective alternative mechanism for payment by reviewed year partners was not included in H.R. 2821. It is helpful that the mechanism allows the adjustment to be reflected on current year returns of reviewed year partners, rather than bringing into play amended returns.

Use of this alternative mechanism can be expected to be attractive to partnerships in which the partners, or the interests of partners, change from time to time because it allows the economic burden of the imputed underpayment to fall upon those who were partners in the year of the underpayment based on their interests in such year. Nonetheless, additional administrative costs, as well as higher interest calculations, would be involved in using the approach.

To the extent that there is an adjustment to be taken into account by a reviewed year partner as a result of the use of the alternative mechanism, there will likely be an increased burden on the partner to determine the increase in tax liability not only for the reviewed year, but also for years subsequent to the reviewed year. For example, if a partner sells its interest between the reviewed and the adjustment year, the partner's basis in the partnership interest may be affected by the adjustment amount. Other tax attributes, such as NOLs, passive activity losses, and other loss limitations, may need to be redetermined as a result of an adjustment amount.

Note also that it is not completely clear how the elective alternative mechanism works in the case of tiered partnerships. For example, if a lower-tier partnership elects to use the alternative mechanism and furnishes an upper-tier partnership with a Schedule K-1 showing an adjustment for the reviewed year, can that upper-tier partnership in turn elect to use the alternative mechanism to pass the adjustment through to its partners (notwithstanding that it was not the partnership that received the notice of adjustment)? How does the "45-day" rule apply in such a situation? Presumably, the mechanism is intended to allow the adjustment to flow up tiers of partnerships. Hopefully, Congress or the IRS will provide clarity on this issue before the new law begins to apply.

Finally, as was indicated above, note that the provisions with respect to the alternative collection regime above appear to only apply to "imputed underpayments." An overpayment would seem to result in an ordinary deduction to partners in the adjustment year (even though the partners of the adjustment year may be different than the reviewed year).

Administrative Adjustment Request (AAR)

The new law imposes a substantially similar approach to payment of tax on an underpayment in the case of administrative adjustment requests filed by the partnership. When a partnership files an administrative adjustment request, the adjustment is taken into account for the partnership tax year in which the administrative adjustment request is made (i.e., the year of the filing, not the prior year). In addition, the payment of tax on an understatement is to be made generally using either the partnership level tax provisions, or under rules similar to the alternative method for payment by partners. When the adjustment would not result in an imputed underpayment, the partnership must use the alternative payment method for payments by partners.

KPMG Observation. In the case of administrative adjustment requests when the partnership is paying the underpayment on the adjustment amount at the partnership level, these rules do not allow the partnership to reduce the adjustment amount by items for which a partner files an amended return. If the partnership elects to have the partners pay the imputed underpayment or if there is an overpayment (i.e., not an imputed underpayment), it is unclear whether the partners of the AAR year or the partners of the year in which the AAR is filed bear the benefits or burdens of the adjustment.

Partnership Representative

The new law requires each partnership that does not elect out of the new regime to designate a partner, or *other person*, with a substantial presence in the United States as the partnership representative ("Partnership Representative"). The Partnership Representative will have the sole authority to act on behalf of the partnership for purposes of the new regime. If the partnership does not make such a designation, the IRS can select any person as the Partnership Representative. Further, the partnership and all its partners will be bound by actions taken under the new regime by the partnership and by any final decision in a proceeding brought under the new regime with respect to the partnership.

KPMG Observation. Given the substantial power accorded the Partnership Representative, this aspect of the legislation could deprive some partners of rights in audit matters and could set up potential conflicts between a partner

designated as the Partnership Representative and those other partners. Nonetheless, the Partnership Representative rules likely were viewed as essential to the legislation, given the issues GAO raised about difficulties the IRS has faced auditing complex tiered partnership structures under the TEFRA rules. In addition, the ability to have any partner or other person serve as the Partnership Representative can be very helpful because it is often difficult to have the IRS approve the designated tax matters partner for settlement purposes or extension of the statute for assessment of partnership items.

Note also that the requirement that the Partnership Representative have a substantial U.S. presence was not in H.R. 2821.

Statute of Limitations

Under the new regime, no adjustment for a partnership tax year can be made after the latest of the date which is three years after the latest of the following three dates: (1) the date on which the partnership return for such tax year was filed, (2) the return due date for the tax year, or (3) the date on which the partnership filed an administrative adjustment request (AAR) with respect to such year.

There are also new rules that allow the period to remain open for adjustment: (1) in the case of any modification of the imputed underpayment, to a date that is 270 days after the date everything required to be submitted is submitted to the IRS; and (2) in the case of any notice of proposed partnership adjustment, to a date that is 270 days after the date of such notice.

KPMG Observation. The statute of limitations rules in the Budget Act are substantially the same as those in H.R. 2821. Query whether allowing the statute to stay open for three years following the filing of an AAR will discourage taxpayers from filing AARs to report additional income or to report fewer tax benefits. Query further why the IRS needs three years to make an adjustment resulting from the filing of an AAR, especially if the partnership pays the tax.

Effective Date

The amendments to the partnership audit rules made by the Budget Act have a delayed effective date. They generally are effective for returns filed for partnership tax years

beginning after December 31, 2017. However, a partnership could elect (at such time and in such manner as prescribed by Treasury) for the provisions to apply earlier.

KPMG Observation. As indicated above, the delayed effective date provides partnerships with an opportunity to evaluate the new rules and to consider whether their partnership agreements need to be updated. The delay also provides some time for the IRS to provide guidance regarding the legislation.

AMENDMENTS TO CODE SECTION 704(e) AND SECTION 761

The Budget Act strikes section 704(e)(1) and changes the heading of section 704(e) to “Partnership Interests Created by Gift” (instead of “Family Partnerships”). It also adds a new sentence to the end of section 761(b) providing that, in the case of a capital interest in a partnership in which capital is a material income-producing factor, whether a person is a partner with respect to such interest will be determined without regard to whether such interest was derived by gift from any other person. These amendments are effective for partnership tax years beginning after December 31, 2015. The section-by-section explanation of the budget agreement explains that:

The provision would clarify that Congress did not intend for the family partnership rules to provide an alternative test for whether a person is a partner in a partnership. The determination of whether the owner of a capital interest is a partner would be made under the generally applicable rules defining a partnership and a partner. In addition, the family partnership rules would be clarified to provide that a person is treated as a partner in a partnership in which capital is a material income-producing factor whether such interest was obtained by purchase or gift and regardless of whether such interest was acquired from a family member. The rule, therefore, is a general rule about who should be recognized as a partner.

KPMG Observation. This provision appears similar to a proposal that was included in the Camp Bill last year. The provision appears to be an expected clarification that the argument made by the taxpayer in the *Castle Harbor* case (*TIFD III-E v. United States*) regarding who is treated as a partner for federal income tax purposes under 704(e) is not valid. *TIFD III-E v. United States*, 459 F.3d 220 (2d Cir. 2006), *rev'g and remanding* 342 F. Supp. 2d 94 (D. Conn 2004).

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