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The Honorable Charles P. Rettig, Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20024

Re: **Areas of Partnership Tax That Require Reform, Part 2:  
Improving Partnership Tax Returns and Partnership Audits.**

Dear Commissioner Rettig:

This is a second letter in a series of letters addressing ideas to improve partnership tax and partnership tax compliance. This letter addresses improving partnership tax returns on Form 1065 and Internal Revenue Service audits of partnerships.

I base this letter on my experiences as a partnership tax practitioner since 1977 and my conversations with other tax practitioners and Internal Revenue Service examiners across the country. I do not have access to the vast information necessary for a comprehensive and systematic study of partnership tax return compliance and partnership audit behavior. My information is limited and anecdotal. My letter presents the view from merely one isolated point among many points of contact for the Internal Revenue Service across the country.

This outlines this letter:

1. Personal Background and Perspective. .... 9
2. Conflicts. .... 9
3. Compensation. .... 10

4.	Pending Matters. ....	10
5.	General Comments.....	10
	Failure of Internal Revenue Service in Auditing Partnerships.....	10
	Low Audit Rate Encourages Abuse. ....	10
	Partnerships Are Playground For Tax Abuse. ....	10
	Only 0.4% of Partnerships Are Audited. ....	11
	If You Cheat on Your Taxes, Use a Partnership .....	11
	Partnership Audits are Ineffective. ....	11
	Why Report Accurately If There Is Only A 1- in-20 Chance of Audit?.....	11
	Partnership Audits Are Notoriously Ineffective.....	11
	Internal Revenue Service Needs Better Information on Form 1065 to Select Returns for Audit and to Undertake Audits.....	12
	Computer Data Analytics Can Identify Returns for Audit and Can Aid Audits.....	13
	A Better Form 1065 Is Required to Fight Noncompliance. ....	15
	Tax Shelter History of Partnerships .....	16
	Partnership Tax Started as Simple Rules for Small Business.....	16
	Massive Regulatory Complexity. ....	16
	Current Complexity of Preparing Partnership Tax Returns.....	17

Increased Sophistication of Compliance	
Software.....	17
Partnership Audits Require Trained Partnership	
Specialists.....	18
Examiners Need Better Pay and Better	
Support. ....	18
Internal Revenue Service Competes	
Unfavorably With Private Industry in	
Recruiting Examiners.....	19
Many Examiners Are Not Comfortable	
Working With Tax Authorities. ....	20
Examiners Typically Raise Only Pedestrian	
Issues in Partnership Audits.....	20
The Internal Revenue Service Is Not	
Altogether A Paper Tiger In All	
Partnership Audits.....	21
Internal Revenue Service Examiners Do Not	
Adequately Understand Many	
Substantive Tax Rules Of Subchapter K.....	21
Examiners Generally Are Not Partnership Tax	
Specialists.....	22
Partnership Examiners Should Have Strong	
Background In Partnership Tax. ....	22
Examiners Should Be Partnership Specialists. ....	22
Examiners Need Specialized Partnership Tax	
Training.....	22

Chief Counsel Attorneys Are Not Routinely Assigned To Support Partnership Tax Audits.....	23
District Counsel Attorneys Have Thin Expertise In Partnership Tax.....	24
Partnership Audits Need Chief Counsel Support. ....	24
Internal Revenue Service Has Inadequate Computational Support Resources. ....	24
Redesign Form 1065.....	25
Partnership Audit Resources Apparently Are Declining. ....	27
Need for Partnership Return and Audit Reform.....	27
Subchapter K Rules Are More Appropriate for Small Partnerships Than For Large Partnerships.....	28
Internal Revenue Service Will Have To Confront Commonly Ignored Partnership Tax Issues.....	28
Increased Return Processing Costs Should Be Recoverable.....	30
Examiners Need Data Analytic Software To Support Audits.....	31
Possible User Fees. ....	31
Advisor Disclosure. ....	31
Partnership Tax Returns' Disclosure of TIN's Creates Significant Data Theft Issues. ....	31

Partnership Tax Is Difficult.....	32
Large Partnerships and Tiered Partnerships Pose Special Substantive Tax Law Issues.....	32
Simplification of Subchapter K.....	33
6. Proposed Actions.....	34
• Redesign Form 1065. ....	34
• Report All Necessary Compliance Information. ....	34
• Provide All Information To Determine Compliance.....	34
• Provide Necessary Partner-Specific Information. ....	34
• Use Data Analytics and Massively Parallel Computing.....	35
• Supplement Data Analytics With Field Audits.....	35
• Attach Operating Agreement.....	35
• Current Year Financial Statements.....	35
• Require Tax and Book Balance Sheets. ....	35
• Organizational Issues. ....	37
• Capital Account Adjustments. ....	38
• Book Capital Accounts Inconsistent With Liquidation Scheme. ....	38
• Revaluations. ....	39
• Capital Shifts. ....	39

- Cash Contributions. .... 39
- Contributions of Partner Notes..... 39
- Property Contributions..... 40
- Assumed Partner Liabilities..... 40
- Contributed Partner Payables. .... 42
- Assumed Partnership Liabilities. .... 43
- Partnership Liabilities. .... 43
- Minimum Gain. .... 45
- Minimum Gain Chargeback..... 45
- Investment Partnership. .... 45
- Service Partners. .... 46
- Unadmitted Partners. .... 50
- Options to Acquire Partnership  
Interests. .... 51
- Phantom Partnership Interests. .... 51
- Participations..... 51
- Organization and Syndication Fees..... 52
- Section 195 Start-up Expenses. .... 52
- Cash and Property Distributions..... 53
- Property Distributions. .... 53
- Nonprorata Cash Distributions..... 54
- Section 734 Computations. .... 54
- Section 737 Computations. .... 54
- Disguised Sales..... 55

- Basis of Partners' Partnership Interests.....55
- Section 704(c)(1)(A) Computations. ....55
- Fill-up Allocations under Section  
704(c)(1)(A). ....56
- Section 704(c)(1)(C) Loss Allocations. ....56
- Section 754 Election. ....56
- Partnership Allocations.....57
- Substantial Economic Effect and  
Partners' Interests in the Partnership.....57
- Substantiality.....58
- Partners' Interests in the Partnership.....58
- Special Allocations to Retiring Partner. ....58
- Changes to Allocations. ....58
- Transitory Tax Credit Allocations.....58
- Section 707(a) Payments.....59
- Guaranteed Payments.....59
- Section 751 Events.....59
- Transfers of Partnership Interests.....59
- Transfers of Indirect Partnership  
Interests. ....60
- Section 743. ....60
- Section 743 Aggregation.....61
- Disproportionate Allocations to Retiring  
Partner. ....61
- Varying Interests Rule.....61

- Direct and Indirect Partners. ....61
- Association of Partnership Return With Entries in Direct and Indirect Partner Returns.....61
- Accounting Fees and Legal Fees. The Form 1065 should disclose any legal fees and accounting fees incurred by the partnership during the year. ....62
- Opinions of Advisors. Any opinions of advisors on which the partnership or a partner intends to rely as a defense against penalties. ....62
- Other Fees.....62
- Tax Shelter Information. ....63
- Upper-Tier Partner Tax Information.....63
- Opportunity Zones. ....63
- Advisor Disclosure.....63
- Electronic Filing Required. ....63
- Data Analytic Software. ....63
- Alternate Partner Identification Numbers. ....64
- Massively Parallel Computer Resources. ....64
- Specialized Examiners. ....64
- Dedicated Partnership Examination Groups.....65
- Robust Training for Partnership Examiners.....65



- Regularly Monitor Private Sector Tax Programs.....65
- Incentive Pay for Partnership Examiners.....65
- Shift Chief Counsel Resources to Partnership Audits.....65
- Consider Simplification of Subchapter K.....66
- Consider Limiting Subchapter K to Small Partnerships.....66
- Consider Creating New Tax Regime for Large Partnerships.....66

**1. Personal Background and Perspective.**

I am an attorney. I am licensed to practice law before the courts of the State of California. I have practiced tax law since 1977.

No one else has endorsed my current comments.

I apologize for any flaws in my discussion or my analysis.

**2. Conflicts.**

I am not lobbying on behalf of any special interest. I write this letter on my own behalf. I do not write on behalf of my law firm, any client, any other organization, or anyone else. My comments stand alone. Neither my law firm, nor any client, nor any other organization, nor anyone else joins in or has endorsed my comments. I expect that many will not agree with some of my comments. Perhaps no one at all will agree with my comments. You can judge on your own whether my comments have merit.

**3. Compensation.**

I have not been offered, I have not received, and I will not receive any compensation in connection with the preparation or submission of my comments – or with any result that they may produce.

**4. Pending Matters.**

To the best of my knowledge, neither my law firm nor any of my clients has any matter discussed in this letter currently under examination by the Internal Revenue Service. I do not have, and I do not believe that my firm or any of its clients has, an immediate, direct financial interest in the outcome of the matters discussed in this letter, other than the general interest of all taxpayers in improving the tax system.

**5. General Comments.**

*Failure of Internal Revenue Service in Auditing Partnerships.* The work of the Internal Revenue Service in auditing partnerships can be characterized by a single word: FAILURE! The failure is almost complete.

*Low Audit Rate Encourages Abuse.* The low audit rate for partnerships has encouraged many taxpayers and advisors to be relaxed in following partnership tax rules. Some partnerships endeavor to apply the tax law rigorously. Some partnerships apply the tax law on a “best efforts” basis. Other partnerships file returns that reflect knowingly disregard of significant provisions in the tax law. These partnerships usually do so with impunity. Either the Internal Revenue Service never audits these partnerships or the examiner does not discover the abuse.

*Partnerships Are Playground For Tax Abuse.* Partnerships have provided taxpayers and advisors a playground for tax abuse. Many partners and advisors have taken full advantage of the opportunities for mischief available.

***Only 0.4% of Partnerships Are Audited.*** The Internal Revenue Service is reported to audit approximately 0.4% of partnerships. That is an incredibly low rate. This low audit rate encourages rather than discourages tax abuse in partnership reporting.

***If You Cheat on Your Taxes, Use a Partnership.*** Sophisticated tax advisors know that, if they have abusive or questionable transactions, then it is often desirable to clothe those transactions in multi-tier partnership structures of partnerships nestled like *matryoshka* dolls.

***Partnership Audits are Ineffective.*** Some partnerships will be audited. Then, the partnership has a low chance of being audited by an examiner who has a reasonable comprehensive knowledge of Subchapter K. The examiner also does not have adequate computational resources available to challenge taxpayer positions for computationally intense adjustments (such as Section 743 adjustments where the partnership has many thousand partners). Those partnership audits that are conducted typically miss important partnership tax issues.

***Why Report Accurately If There Is Only A 1-in-20 Chance of Audit?*** Taxpayers may ask themselves why they should report partnership returns accurately if there is only a 1-in-20 chance of being caught if they lie, cheat, and steal on their returns. That 1-in-20 figure, however, badly underestimates the problem.

***Partnership Audits Are Notoriously Ineffective.*** Most partnership tax audits of those 1-in-20 partnerships deal with only minor audit issues such as travel and entertainment and documentation of expenses. Few partnership tax audits consider real partnership tax issues under Subchapter K. Internal Revenue Service examiners are unable or unwilling to explore more complicated partnership tax issues. Internal Revenue Service examiners typically are tax generalists. These examiners must work across an impossibly broad range of federal tax issues.

A partnership may be audited. The chances of having an examiner who is reasonably knowledgeable in Subchapter K are remote. The Internal Revenue Service examiner usually does not understand partnership tax law well. Examiners who audit partnerships typically go after low hanging fruit. Examiners examine issues that they know and understand well. The examiner often will go after simple and familiar issues such as travel and entertainment and documentation of partnership deductions. The examiner rarely is in a position to challenge Section 704(c) computations, Section 734, 743, and 755 computations, issues of substantial economic effect, fill-up allocations, special allocations, liability sharing, disguised sales, Section 751 events, and the like. This overall situation encourages partnership tax shelters and application of partnership tax rules in an aggressive or abusive manner. Partnerships often resolve all doubts in the partnership tax law in their own favor. The Internal Revenue Service has no idea of the revenues that are lost each year on account of partnership tax abuses.

Most audits that do produce real partnership tax issues are audits of consolidated corporate groups.

***Internal Revenue Service Needs Better Information on Form 1065 to Select Returns for Audit and to Undertake Audits.*** The Internal Revenue Service detects and selects potentially fraudulent, abusive, and otherwise inaccurate partnership tax returns to initiative tax examinations by Internal Revenue Service examiners in the field. The current information available to the Internal Revenue Service in electronic form is not adequate for the Internal Revenue Service to detect questionable or fraudulent tax positions taken on partnership tax returns.

More and higher quality partnership tax audits are necessary for fair and equitable application of the tax laws. The Internal Revenue Service needs better-reported information to promote the highest degree of voluntary compliance through equitably selecting for audit returns

that indicate the probability of substantial error. The current situation results in substantial revenue loss and in uneven application of the tax laws depending on taxpayer aggressiveness.

***Computer Data Analytics Can Identify Returns for Audit and Can Aid Audits.*** The development of more comprehensive Form 1065 return disclosure and the use of advanced computer-based data analytic techniques and various data sources to assign scores to partnership returns based on characteristics of abuse can help to identify inaccurate taxpayer returns for audit.

Additional data sources include prior-year tax returns, direct and indirect partner returns, and higher-tier flow-through indirect partner returns.

Analytical software and high performance computing –

- Can identify, highlight, and score issues for examination.
- Can apply consistent objective criteria for audit selection.
- Can reduce inequities resulting from hand review of returns for audit selection.
- Can reduce geographical differences in return selection.
- Can help to identify the returns with the highest probability of noncompliance.
- Can apply automated analytical processes that rely on reported information, historical data, coring mechanisms, and data-driven algorithms.
- Can identify mathematical errors.
- Can identify clerical errors.
- Can identify taxpayer positions that are inconsistent with the tax law.
- Can identify other errors in application of the tax law.

- Can run filters, rules, and algorithms to identify noncompliance.
- Can result in correction notices automatically mailed to taxpayers.
- Can improve the application of the discriminant index function to score a particular tax return based on characteristics.
- Can enable matching of partnership returns and reported information on direct and indirect partnership returns.
- Can aid in identification of high income nonfilers (with known sources of income exceeding \$200,000).
- Can associate partnership tax returns with advisors with a history of tax abuse.
- Can review normal return computations.
- Can determine the correct application of the tax law.
- Can detect transactions that should result in return adjustments (such as Section 743 adjustments).
- Can highlight issues for examiner review and development.
- Can determine the presence of specific tax issues known or suspected to have high noncompliance (including noncompliance in a particular geographic area or industry).
- Can provide data matching between direct and indirect partners and the partnership.
- Can associate partnership tax returns with return preparers identified with tax abusive and tax shelter transactions.
- Can aid the Internal Revenue Service in dealing with taxpayer requests for adjustments to partnership tax returns.

- Can aid in identifying abusive promoters and tax preparers.
- Can aid in the identification of tax shelters.
- Can aid in the identification of nonfilers.
- Can automatically resolve many tax issues by correspondence audit.
- Can identify other issues for field examination.

Both correspondence audits and field audits will benefit from more comprehensive computer data analytics. Analytical software can provide the examiner with powerful tools to undertake partnership tax audits and to correct abuse and fraud.

The computer field has greatly expanded the use of cost-efficient high performance computing with massive parallel processing (involving the use of hundreds of thousands of core processors) for data analytics and massive computer storage. Computer systems that can handle the data analytics tasks indicated in this letter should be available. The computer data processing and storage requirements should be similar to those that are routinely handled by major computer consumers, such as Google and Microsoft. The computational task for handling comprehensive analysis of partnership tax returns should be comparable to the computational task undertaken by major search engines. Vendors already have substantial experience in similarly massive tasks.

Until the Internal Revenue Service expands the information required on Form 1065 and undertakes advanced computer data analysis of all partnership returns, the Internal Revenue Service will not have the information needed to identify noncompliance and fraud.

***A Better Form 1065 Is Required to Fight Noncompliance.*** Tax noncompliance costs the federal government hundreds of billions of dollars annually. The partnership tax area appears to be a major area for noncompliance that has received scant attention from the Internal

Revenue Service beyond concerns about marketed tax shelter transactions. The Internal Revenue Service's current program of examination of partnership tax returns is wholly inadequate. Form 1065 does not currently provide adequate information disclosures in order to permit sound evaluation of partnership tax returns for audit. Examiners are not properly trained to detect tax abuse. Examiners are not supported by adequate computational resources to deal with the computational audit issues of large partnerships.

***Tax Shelter History of Partnerships.*** Partnerships have an unfortunate history of use as tax shelter vehicles. Partnerships have often been used for tax-abusive transactions. Syndicators have formed many tax shelter investments as partnerships. Taxpayers can use partnerships not formed as tax shelters in a tax-abusive manner, such as with fill-up allocations to retiring partners that divert substantial amounts of partnership income to tax-indifferent partners. Even nonabusive partnerships often do not follow the partnership tax law well.

***Partnership Tax Started as Simple Rules for Small Business.*** Subchapter K started as a comparatively user-friendly set of rules to allow flexibility for small businesses. Congress and the Internal Revenue Service did not design partnership tax rules for partnerships with thousands, tens of thousands, or even hundreds of thousands of partners. Some of the partnership tax rules do not work well when applied to partnerships with thousands, tens of thousands, or even hundreds of thousands of partners. Applying substantive partnership tax rules in audit to partnerships with thousands, tens of thousands, or even hundreds of thousands of partners is difficult.

***Massive Regulatory Complexity.*** The Congressional and Internal Revenue Service response to the aggressive use of partnerships for tax planning has resulted in many changes to the rules of Subchapter K and in massive regulations. The current regime governing taxation of partnerships is highly complex and regulated by a massive body of



regulations. Few, if any, partnership tax practitioners can honestly say that they understand all of Subchapter K. The highly complex tax law and the mass of long, complex regulations heavily burden compliance for partnerships.

***Current Complexity of Preparing Partnership Tax Returns.*** The increased complexity of Subchapter K has resulted in a massive increase in the complexity of preparing partnership returns. Some practitioners, in frustration, have developed their own conventions for applying the partnership tax law. Some practitioners take advantage of ambiguities in the partnership tax law. Few Internal Revenue Service examiners feel comfortable with partnership tax audits.

***Increased Sophistication of Compliance Software.*** The coming trend in partnership tax compliance appears to include the development of “cradle to grave” computerized partnership tax compliance software that purports to handle the broad range of partnership tax computations from the formation of a partnership through liquidation of the partnership. Accounting staff inputs the new raw information each year. The software produces finished results without necessarily providing detailed explanations of all of the computations or the methodologies that the software incorporates.

Software can automate reporting of these issues:

- capital account maintenance,
- capital contributions,
- partner basis in partnership interest,
- partnership disguised sales,
- allocation of partnership liabilities among partners,
- Section 704(b) allocations,
- Section 704(c) allocations,

- partnership book-ups,
- reverse Section 704(c) allocations,
- partnership guaranteed payments,
- partnership basis adjustments under Section 734 and Section 743,
- Section 751 computations,
- gain on distributions,
- varying interests rule, and
- liquidation of a partner.

Compliance software – existing software and software still to be developed – can make effective Internal Revenue Service partnership tax audits difficult or impossible unless the Internal Revenue Service receives raw information in electronic form and the Internal Revenue Service has comparable computational software and computing resources.

The Internal Revenue Service needs to be able to deal with audits of partnerships that use this “cradle to grave” software where there are many millions (or even hundreds of millions) of underlying computations that cannot easily be replicated by the Internal Revenue Service examiner working by hand.

***Partnership Audits Require Trained Partnership Specialists.*** Partnership tax audits require experienced, highly trained, motivated partnership tax specialists. Internal Revenue Service examiners normally are not experienced, highly trained partnership tax specialists.

***Examiners Need Better Pay and Better Support.*** The Internal Revenue Service needs to provide better pay for examiners and to provide examiners with better support.

The Internal Revenue Service offers examiners low pay to start work with the Internal Revenue Service and low pay throughout their career path.

Being an Internal Revenue Service examiner is not a particularly socially attractive endeavor for a recent college graduate. Go to a party and tell the other guests that you are an Internal Revenue Service examiner. This is an instant invitation to being shunned.

*Internal Revenue Service Competes Unfavorably With Private Industry in Recruiting Examiners.* The Internal Revenue Service competes unfavorably in recruiting graduates for positions as field examiners with many accounting firms that also recruit in accounting schools (but that pay much higher starting salaries and offer more remunerative career paths). Even many senior Internal Revenue Service personnel – even at the associate chief counsel level – leave the Internal Revenue Service for the ranks of large accounting firms where they are much better paid and better supported and work under better working conditions.

Internal Revenue Service offices are Spartan. These offices are much less comfortable than the opulent offices of major accounting firms.

Internal Revenue Service training and travel budgets have been cut drastically. Congress has desperately overreacted to perceived Internal Revenue Service abuses by seeking to punish the Internal Revenue Service by dramatically reducing training and travel budgets. The Internal Revenue Service does not offer examiners adequate training to do their jobs, particularly in partnership examinations. Even before these cuts, Internal Revenue Service examiners received inadequate training in partnership tax. Internal Revenue Service examiners typically receive less training in partnerships than their counterparts in the private sector. Recently, it has taken months for the Senate to confirm its new Chief Counsel.

The Internal Revenue Service rarely approves examiner attendance at tax conferences offered by the private sector. Examiners should attend these conferences in order to identify tax issues for audit and to be able to deal effectively with complex partnership tax issues. In addition, the current Internal Revenue Service examiner assignment model does not permit examiners to specialize in partnership tax. Partnership examiners should be partnership tax specialists.

***Many Examiners Are Not Comfortable Working With Tax Authorities.*** Many examiners are uncomfortable working directly with the Internal Revenue Code, Treasury Regulations, and other tax authorities. Some of the most complex Treasury Regulations govern partnership tax. Anyone who works with partnership tax should be fully comfortable with the Internal Revenue Code and Treasury Regulations. Partnership tax work requires regularly working with the Internal Revenue Code, Treasury Regulation, and other authorities. Notably, Internal Revenue Service field offices often do not have readily available treatises and other secondary resources on partnership taxation.

On the whole, it is remarkable that the Internal Revenue Service has so many dedicated, hard-working, well-motivated examiners as it does.

***Examiners Typically Raise Only Pedestrian Issues in Partnership Audits.*** My colleagues tell me that the Internal Revenue Service examiners raise in partnership tax audits only routine issues not involving tax issues of Subchapter K. Practitioners often comment that, when their partnerships had large transactions with significant Subchapter K issues, the Internal Revenue Service completely ignored those issues. When the Internal Revenue Service did identify real Subchapter K issues, the examiners were not able to pursue these issues aggressively.

The Internal Revenue Service has publicly identified complex and cumbersome TEFRA audit rules as a cause for not auditing partnerships.

Congress and the Internal Revenue Service have replaced these rules with considerably more complex and cumbersome partnership audit rules.

***The Internal Revenue Service Is Not Altogether A Paper Tiger In All Partnership Audits.*** The Internal Revenue Service sometimes can be formidable in partnership audits, particularly partnership tax shelter audits and audits of expense documentation and travel and entertainment. The Internal Revenue Service nevertheless is not the formidable tiger in partnership audits that it would be if the Internal Revenue Service properly trained and supported examiners and the Internal Revenue Service adopted data analytic software to review all partnership tax returns.

***Internal Revenue Service Examiners Do Not Adequately Understand Many Substantive Tax Rules Of Subchapter K.*** An important cause for the Internal Revenue Service not auditing partnerships effectively is that Internal Revenue Service examiners do not adequately understand the vastly complicated substantive tax rules of Subchapter K. An embarrassing reality is that the Internal Revenue Service's first line of defense in applying Subchapter K in practice – the Internal Revenue Service field examiner – does not understand the tax law that applies to partnerships. (To be fair, many accountants and attorneys outside of the Internal Revenue Service are deficient in their knowledge of the tax law that applies to partnerships.) The examiners' lack of proficiency in Subchapter K reflects –

- inadequate funding and staffing of the Internal Revenue Service,
- the failure of the Internal Revenue Service to provide adequate skills training (a result of inadequate Internal Revenue Service funding),

- the failure of the Internal Revenue Service to permit examiners to attend partnership tax courses provided by third party providers,
- inadequate Internal Revenue Service salaries and incentives,
- difficulties of the Internal Revenue Service in competing with private industry for net hires as examiners, and
- failure of the Internal Revenue Service to develop sophisticated software to support partnership audits.

***Examiners Generally Are Not Partnership Tax Specialists.*** Internal Revenue Service examiners who audit partnership tax returns typically are not partnership tax specialists. In large partnership tax audits, these examiners often face CPAs or attorneys who are specialists in partnership tax audits or partnership taxation. These CPAs or attorneys often have excellent training and many years of experience in partnership taxation. Many are former counsel with the Chief Counsel's office or District Counsel.

***Partnership Examiners Should Have Strong Background In Partnership Tax.*** Partnership taxation has become extraordinarily complex. It is often difficult for even the most able tax practitioners to apply. Partnership tax rules can be particularly difficult to apply to large partnerships with many partners and to tiered partnership arrangements. Effective partnership audits require that the examiner have a strong background in substantive partnership tax.

***Examiners Should Be Partnership Specialists.*** The Internal Revenue Service should permit examiners to specialize in partnership tax audits. The Internal Revenue Service should provide specialty pay to these examiners.

***Examiners Need Specialized Partnership Tax Training.*** The Internal Revenue Service also should provide these examiners with substantial, enhanced training in basic, intermediate, and advanced

partnership tax issues. To the best of my knowledge, this training does not exist within the Internal Revenue Service, and the expertise to give this training may be rare outside of the Chief Counsel's office.

*Chief Counsel Attorneys Are Not Routinely Assigned To Support Partnership Tax Audits.* The Chief Counsel's office is the Internal Revenue Service's repository of its most sophisticated knowledge of substantive partnership tax. The situation in the Chief Counsel's office is somewhat better and standards that are more reasonable prevail there than for examiners in the field.

Nevertheless, attorneys working for the Chief Counsel usually spend most of their time working on private letter rulings or on regulations projects and not in direct support of partnership tax audits. The Chief Counsel's office does not routinely assign its attorneys to support partnership tax audits. Most partnership audits do not have attorneys from the Chief Counsel's office assigned for legal support. Examiners often are reluctant to raise issues to the Chief Counsel's office.

Many attorneys in the Chief Counsel's office – often some of the best counsel – choose to leave government service to join large accounting firms or law firms. Most partnership tax audits do not have Chief Counsel support.

Many partnership tax issues are challenging and require expertise. In private practice, these issues often are handled by tax attorneys with advanced degrees in taxation and strong experience in partnership tax planning. Accountants in private practice also can handle this work, but these accountants have training and experience parallel to partnership tax attorneys. Many partnership audits require a highly trained partnership tax professional – whether an attorney or accountant. These highly trained partnership tax professionals are rare in the Internal Revenue Service outside of the Chief Counsel's office.

***District Counsel Attorneys Have Thin Expertise In Partnership Tax.*** Additionally, District Counsel attorneys usually have thin expertise in substantive partnership tax. District Counsel often are reluctant to become involved in technical partnership cases.

The Internal Revenue Service partnership tax examiner often is adrift on his own in a partnership tax audit.

The Internal Revenue Service examiner often does not know the partnership tax law that applies to his audit. This makes it difficult for the examiner to undertake a comprehensive and robust audit.

***Partnership Audits Need Chief Counsel Support.*** The Internal Revenue Service also should provide substantial Chief Counsel technical support to partnership tax audits. In an era of severely limited Internal Revenue Service budgets, this likely will require diversion of Chief Counsel personal from other tasks to support of partnership tax audits.

Many large partnerships or multitier partnerships find it difficult to comply, or they are otherwise unwilling to comply, with the rules of Subchapter K. These partnerships often invent their own tax conventions for completing their tax returns. Comprehensively auditing these partnerships for correct application of the rules of Subchapter K often is an overwhelming task. The analysis of some rules of Subchapter K in the context of large partnerships (for example, a comprehensive analysis of substantiality of allocations) is almost impossibly difficult.

***Internal Revenue Service Has Inadequate Computational Support Resources.*** Private sector taxpayer representatives have substantial support resources. These resources may include computational resources (which are particularly important for many partnership transactions that result in complex basis adjustments), national office technical expertise, valuation expertise, and other recourses, in addition to support by the partnerships' internal accounting staffs. There typically is no comparison



between the support available to the taxpayer representatives and the support available to the Internal Revenue Service partnership examiner.

***Redesign Form 1065.*** The Internal Revenue Service's only hope of meeting current reporting and audit challenges requires the Internal Revenue Service completely to redesign Form 1065. Form 1065 should provide detailed information necessary to select returns for audit and provide all information necessary for data analytics and high performance computing through massively parallel computing to undertake an analysis of partnership returns for possible noncompliance. Ideally, partnerships should provide sufficient information with their Form 1065 filings to permit computer data analytics to indicate proper audit subjects and, if possible, to resolve compliance with the partnership tax laws. Many partnership tax audit subjects can be reduced to doing partnership tax computations accurately using the correct methodology.

The starting point in developing a new Form 1065 should be an analysis of what the basic partnership tax audit issues should be and what basic facts (including dates and quantitative information) are necessary to develop those issues in a comprehensive tax audit of the partnership. The Form 1065 should disclose as much information as practically possible to enable a comprehensive tax audit of the partnership. The availability of this information in electronic form will enable the Internal Revenue Service to use high performance computing and data analytics to select returns for audit, to identify audit issues, and to determine the proper outcome of most partnership tax issues. To develop this information, the Internal Revenue Service should consult its examiners. The Internal Revenue Service should determine: what information it needs in order to select partnership returns for audit. The Internal Revenue Service should establish what information it needs in order to audit partnership returns effectively. The Internal Revenue Service should require the reporting of this information in a form that

can be digested by computers using data analytics. The information requirements should center on: what information is necessary for computer software to analyze and to resolve the normal tax issues over the history of the partnership. As much as possible, the Form 1065 should contain sufficient information necessary to resolve these issues. The Form 1065 should be designed so that it is an examiner's dream in disclosing audit related information.

This study should involve a situation-by-situation analysis, including such issues as:

- Organization and syndication fees.
- Partnership formation.
- Investment partnerships.
- Partnership disguised sales.
- Investment partnership rules.
- Transfers of partnership interests.
- Computation of partner basis in partnership interests.
- Determination of partnership taxable year.
- Closing of taxable year.
- Application of varying interests rule.
- Partnership interests created by gift.
- Basis loss limitations on loss flow-through.
- Guaranteed payments.
- Partnership allocations.
- Section 704(c).
- Redemption of a partner.
- Liquidation of the partnership.

- Partnership distributions.
- Varying interests rule.
- Allocation of liabilities.
- Basis of a partner's interest.
- Partnership taxable year.
- Carried interest computations.
- Section 751 computations.
- Section 734, 743, and 743 computations.

***Partnership Audit Resources Apparently Are Declining.*** Internal Revenue Service resources devoted to partnership tax audits seem to be declining rather than increasing. This may reflect competition among scarce financial resources in the federal budget. Underfunding the Internal Revenue Service also may reflect either indifference or hostility to its mission of determining and collecting taxes.

***Need for Partnership Return and Audit Reform.*** The Internal Revenue Service should rethink and reconsider methods of reporting partnership tax returns and audit of partnership tax returns and its training and deployment of examiners. I believe that the only hope for the Internal Revenue Service partnership examiner under the current tax law is to require considerably more detailed partnership reporting on Form 1065 so that partnership returns can be selected for audit and a substantial portion of the audits can be conducted by the use of computers and sophisticated data analytics. Data analytics should be able to determine compliance with the partnership tax laws in most cases and to identify situations of noncompliance or probable noncompliance. Data analytics will improve selection of tax returns for audits. Data analytics will help to identify audit issues for examiners. Data analytics can provide the computational support that examiners require in connection with partnership audits. Data analytics also can be important

in determining modifications of imputed underpayments in partnership audits.

***Subchapter K Rules Are More Appropriate for Small Partnerships Than For Large Partnerships.*** The rules of Subchapter K are more appropriate for small businesses rather than large partnerships with hundreds or thousands of partners and perhaps many tiers of partnerships as partners. The current rules of Subchapter K may be inappropriate for large partnerships and for partnerships with many tiers of partnerships as partners.

The Internal Revenue Service should consider whether it is appropriate for these large partnerships to be governed by the rules of Subchapter K. I believe that it is not. If Subchapter K should not include these large partnerships, then Congress should accordingly amend the tax law. I suggest that the current rules of Subchapter K should be limited to partnerships with no more than 100 direct and indirect partners.

The Internal Revenue Service should consider whether a new regime should be developed to govern large entities that are now taxed as partnerships under Subchapter K. These rules might require recognition on all property distributions and contributions. These rules might require all partnership allocations be made in accordance with percentage interests. These rules might eliminate Sections 734, Section 743, and Section 754. These rules might limit or eliminate flow through of net losses to partners. These rules might eliminate liabilities from increasing a partner's basis in his partnership interest. A large partnership failing to meet the requirements of these rules would be taxed as a corporation.

***Internal Revenue Service Will Have To Confront Commonly Ignored Partnership Tax Issues.*** The data analytics requirements should be challenging, but not an unmanageable task. The programming task will require the Internal Revenue Service to consider many partnership

tax issues that the Internal Revenue Service generally has ignored in the past. Effective data analytics should require the Internal Revenue Service to identify a position on normal tax issues that Internal Revenue Service examiners encounter in audits that the Internal Revenue Service has avoided. Issues could include, among many others:

- tax effects of receipt of a capital partnership interest for services,
- tax effects of issuance of a profits interest in a partnership for services,
- measuring percentage capital interests in a partnership,
- measuring percentage profits interests in a partnership,
- drop and swap exchanges,
- swap and drop exchanges,
- targeted allocations,
- substantiality of allocations,
- details of qualified income offset,
- partners' interests in the partnership,
- application of substantial economic effect and partners' interests in the partnership to targeted allocations,
- fill-up allocations under Section 704(b),
- fill-up allocations under Section 704(c),
- asset aggregation under Section 704(c),
- treatment of tiers of reverse Section 704(c) adjustment,
- aggregation of Section 704(c) adjustments with reverse Section 704(c) adjustments,

- assumed purchase price of assets in connection with Section 743 adjustments,
- assumed transfer date in connection with Section 704(c) adjustments,
- special allocations to retiring partners,
- special allocations in connection with tax credit partnerships,
- substantiality of economic effect in connection with tax credit partnerships,
- special allocations to service partners,
- use of guaranteed payments to zero out capital accounts on liquidation,
- cashless capital contributions based on special allocations to partners,
- guaranteed payments restructured as preferred distributions and preferred allocations,
- determination of what payments are guaranteed payments,
- distribution schemes that profits distributions to one partner to return of capital to another partner,
- revaluation of assets and adjustment of capital accounts where the partnership uses targeted allocations,
- aggregation under Section 704(c) where a partnership does not currently qualify as a securities partnership, and
- Section 751 transactions.

***Increased Return Processing Costs Should Be Recoverable.*** The benefits in increased accuracy in reporting in the partnership component of the tax system should be major. The increased processing costs

should be easily recoverable in a short period of time with increased compliance and increase in Internal Revenue Service audit quality.

In addition, Congress should consider the possibility of imposing user fees on filing partnership tax returns and on each direct and indirect partner in a partnership. These user fees could help to recover software development fees, hardware costs, and other costs in connection with partnership audits.

***Examiners Need Data Analytic Software To Support Audits.*** Without developing data analytic software that can undertake the integrated task of undertaking all required partnership computations and identifying return deficiencies, the Internal Revenue Service examiner has little chance of doing an effective job in auditing partnership returns. The task is completely overwhelming for many partnership audits, even if the examiner has a comprehensive knowledge of partnership taxation.

***Possible User Fees.*** In light of the considerable compliance and audit effort required in connection with partnership tax returns, it may be appropriate for Congress to impose user fees on every entity that files a partnership tax return, or perhaps on partnerships that meet certain criteria (such as a minimum number of partners). The Internal Revenue Service might impose a basic user fee for each Form 1065 and an additional user fee for each direct or indirect partner. This user fee could help to underwrite the additional audit costs that result from the use of partnerships. These fees could be set at a level so that they fully underwrite the cost of auditing partnerships.

***Advisor Disclosure.*** History shows that partnership scams and abuses are often associated with particular partnership practitioners.

***Partnership Tax Returns' Disclosure of TIN's Creates Significant Data Theft Issues.*** Thoughtful taxpayers have become protective of their taxpayer identification numbers (TINs). TIN compromise unfortunately has become a major tool in data theft. The Internal Revenue Service

should exercise all diligence in preventing the compromise of TINs in order to minimize data theft.

The partnership is required to list the TINs of all partners on its Form 1065, Schedule K-1.

Partnerships often provide complete Forms 1065 to their partners and to others. Partners also may have access to Forms 1065 through state law provisions that permit partners to access and to copy books and records of the partnership. Even when a partner leaves the partnership or a partnership representative resigns, his TIN information remains with the partnership.

Instructions to Form 1065 permit redaction of partial TIN information when the partnership provides partnership tax returns to others. That TIN information, however, often is not redacted in practice.

The Internal Revenue Service could aid the cause against data theft by issuing to partners a special partner identification number to be reported on partnership tax returns rather than the partner TIN. Appropriate charges could be made for these identification numbers. Compromise of partner identification numbers should not advance data theft.

***Partnership Tax Is Difficult.*** Partnership tax is exceedingly difficult. Few tax attorneys or tax accountants – even those with post-graduate degrees in taxation – are very comfortable with the nuances of partnership tax beyond fairly basic transactions. Regulations are long and often nearly impenetrable. Regulations often are ambiguous and difficult to interpret.

There is much about partnership tax that is not fully understood.

***Large Partnerships and Tiered Partnerships Pose Special Substantive Tax Law Issues.*** With large partnerships and tiered partnerships, theoretical questions often become more difficult.



Computations become considerably more complicated. Accountants often have difficulty keeping up with these complicated computations. These accountants typically have much better computational and computer resources available for these computations than Internal Revenue Service examiners have available for their audits.

The playing field for a partnership tax audit is uneven. The Internal Revenue Service examiner is not properly trained or resourced. The examiner often does not know the applicable law. The examiner typically does not have adequate computer data analytics resources available for the audit.

***Simplification of Subchapter K.*** The rules of partnership taxation have become impossibly complicated. Most modern regulations projects in the partnership area result in regulations that go on for hundreds of pages. Partnership specialists have difficulty keeping up on the regulations. My impression is that much of the regulations is simply beyond the typical examiner.

The operation of Subchapter K becomes particularly difficult with many tiered partnership tax problems.

The practical operation of Subchapter K can become exceedingly complex with partnerships that contain large numbers of direct and indirect partners. Issues such as the varying interests rule, capital account revaluations, reverse Section 704(c) computations, Section 743 adjustments, Section 751(b), cashless capital contributions of service partners, tracking allocations, allocations with respect to loss assets, and disguised sale rules become computationally unwieldy in the case of large partnerships with many partners.

The current legislative trend is to make Subchapter K more complicated in order to counter perceived tax abuses with partnerships. The remedial provisions have added hundreds of pages of regulations. The remedial provisions have vastly increased the complexity of

Subchapter K. It would seem appropriate to go back to the basic operating provisions of Subchapter K to see if it is possible to simplify Subchapter K and yet to counter tax abuse. I shall discuss this in a subsequent letter.

## 6. Proposed Actions.

I propose these reforms:

- ***Redesign Form 1065.*** The Internal Revenue Service should redesign Form 1065 to facilitate computer-based audits of partnerships using data analytics and high performance computing.
- ***Report All Necessary Compliance Information.*** Form 1065 should report all necessary information to evaluate partnership compliance with the provisions of Subchapter K.
- Information required should include all information reasonably necessary to determine compliance with partnership tax laws:
- ***Provide All Information To Determine Compliance.*** The goal of the Form 1065 should be to provide all information necessary (including, where appropriate, partner information) to determine and to report compliance with the partnership tax laws and to undertake all partnership-related computations, all in an electronic form as approved by the Internal Revenue Service.
- The proposed Form 1065 would contain all raw information required to make return-related computations, in addition to the finished results.
- ***Provide Necessary Partner-Specific Information.*** The Form 1065 also should contain direct and indirect partner-

specific information (such as information related to Section 743 adjustments), as necessary for partnership-level issues. The following list merely provides examples and is by no means comprehensive. A comprehensive list will require a more careful and systematic review of the Code, regulations, and other authorities.

- ***Use Data Analytics and Massively Parallel Computing.*** The goal of the computer-based data analytics audit is to use data analytics both to select partnership tax returns for audit and to develop audit issues to the extent practical. Information may be processed using high performance massively parallel computing.
- ***Supplement Data Analytics With Field Audits.*** The Internal Revenue Service can supplement data analytics audits, to the extent necessary, by field audits by Internal Revenue Service examiners.
- ***Attach Operating Agreement.*** The Form 1065 should attach the partnership agreement, operating agreement, articles of organization, and all amendments as exhibits.
- ***Current Year Financial Statements.*** Current year financial statements of the partnership.
- ***Require Tax and Book Balance Sheets.*** The Form 1065 should contain fully detailed balance sheets (showing an asset-by-asset and liability-by-liability presentation).
  - The partnership should state one balance sheet based on adjusted tax basis.
  - The partnership should state a second balance sheet based on Section 704(b) book.

- The partnership should state the balance on an asset-by-asset, liability-by-liability line item basis.
- The Form 1065 should disclose for every partnership asset (on the balance sheet or elsewhere),
  - identity of the asset,
  - date acquired by a contributing partner, if appropriate,
  - the partner contributing the asset to the partnership (if any),
  - the cost of the asset,
  - its date placed in service,
  - its date acquired by the partnership,
  - all historical adjustments to basis (by year),
  - its depreciation method,
  - its depreciation life,
  - its character as a capital, Section 1231, or ordinary asset,
  - all Section 743 or Section 734 adjustments,
  - date of all Section 743 or Section 743 adjustments,
  - all historical adjustments to Section 743 or Section 743 basis (by year),
  - depreciation method for Section 743 or Section 734 adjustments,
  - depreciation life for Section 743 or Section 734 adjustments, and

- depreciation of all Section 743 and Section 734 adjustments.
- ***Organizational Issues.*** For a newly-formed partnership,
  - The Form 1065 should attach:
    - private placement memorandum,
    - prospectus,
    - similar documents, and
    - any agreements with brokers or sales agents.
  - The Form 1065 should disclose whether any partners claim an itemized deduction for a legal fee, tax advice fee, surety fee, *etc.*, incurred in connection with the partnership.
  - The Form 1065 should disclose organizational costs that the general partner or organizer of the partnership incurred.
  - The Form 1065 should disclose whether there is a first-year management fee, or a guarantee of a set amount of profit, in the early years of the partnership that compensates the organizing partner for organization costs.
  - The Form 1065 should disclose legal and accounting fees related to organization of the partnership.
  - The Form 1065 should disclose and itemize syndication costs of the partnership.
  - The Form 1065 should disclose a written description of duties performed by the promoter/partner.
  - The Form 1065 should disclose what portion of promoter/partner fees is related to –

- syndication costs,
  - organizational costs,
  - start-up costs, and
  - asset acquisition.
- The Form 1065 should disclose what time the promoter/partner spent in organization of the entity.
  - The Form 1065 should disclose who organized the entity and how was he/she compensated.
  - The Form 1065 should disclose whether the partnership used brokers or agents to sell partnership interests (and what they were paid).
  - The Form 1065 should disclose when the partnership business began.
  - The Form 1065 should disclose what expenses were incurred prior to the opening of the business of the partnership (and the person incurring these expenses).
- ***Capital Account Adjustments.*** The Form 1065 should contain a complete history of adjustments to each partner's capital account.
  - ***Book Capital Accounts Inconsistent With Liquidation Scheme.*** The Form 1065 should provide an explanation of any situation in which Section 704(b) capital accounts do not equal Section 704(b) assets reduced by liabilities.
  - The Form 1065 should provide an explanation of any situation in which a partner's Section 704(b) capital account does not equal the amount that the partner would receive

on liquidation of the partnership if the partnership liquidated at Section 704(b) book value.

- **Revaluations.** The Form 1065 should provide an explanation of any event of revaluation of Section 704(b) capital accounts, the justification for the revaluation, how the fair market value of assets was determined, the business purpose for the revaluation, and the revaluation amount that each partner received.
- **Capital Shifts.** The Form 1065 should provide detailed disclosure of all capital shifts among partners.
- **Cash Contributions.** The Form 1065 should disclose –
  - all partner cash capital contributions,
  - contributing partner,
  - date of contribution, and
  - amount of contribution.
- **Contributions of Partner Notes.** The Form 1065 should disclose –
  - contributions of partner promissory notes (with copies of the promissory note attached to the Form 1065),
  - contributing partner,
  - terms of note,
  - interest rate,
  - required payments to date,
  - actual payments to date,
  - unpaid principal amount at end of year, and

- cancellations or reductions in note balance other than by payment.
- ***Property Contributions.*** The Form 1065 should specially report ( on an asset-by-asset basis) –
  - contributing partner identity,
  - all property contributions of the partner to the partnership,
  - status of asset under Section 724,
  - description of contributed asset,
  - whether property transferred is intangibles,
  - date of contribution,
  - fair market value,
  - description of methodology for determining fair market value (including copies of any appraisals),
  - whether an appraisal of the contributed property was undertaken (if so, attach appraisal),
  - adjusted tax basis,
  - computation of adjusted basis of contributed property,
  - computation of gain on the contribution, and
  - when a partner contributes encumbered property, whether the partner relieved of more liabilities than the adjusted basis in his partnership interest.
- ***Assumed Partner Liabilities.*** The Form 1065 should disclose on a liability by liability basis –
  - all liabilities assumed or taken subject to from a partner,



- partner from which liability is assumed or taken subject to,
- whether liability is secured,
- property securing liability,
- date of transfer of liability
- date on which liability was incurred,
- whether liability is a qualified liability and why liability is a qualified liability,
- whether liability was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and whether the liability has encumbered the transferred property throughout that two-year period,
- whether the liability is a liability that was not incurred in anticipation of the transfer of the property to a partnership, but the liability was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and the liability has encumbered the transferred property since it was incurred,
- whether the liability is a liability that is allocable under the rules of section 1.163-8T to capital expenditures with respect to the property,

- whether the liability was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held,
- whether all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business, and
- whether the liability is a liability that was not incurred in anticipation of the transfer of the property to a partnership,
  - whether the liability was incurred in connection with a trade or business in which property transferred to the partnership was used or held,
  - what assets related to that trade or business are transferred,
  - what assets related to that trade or business are not transferred, and
  - whether all nontransferred assets related to the trade or business are not material to a continuation of the trade or business (and why these assets are not material to the continuation of the transferred trade or business).
- ***Contributed Partner Payables.*** The Form 1065 should disclose with respect to cash basis payables contributed to the partnership by a partner –
  - the amount of the cash basis payables,
  - the contributing partner, and

- whether any resulting deduction from the payment of the payables has been allocated to the contributing partner.
- ***Assumed Partnership Liabilities.*** The Form 1065 should disclose on a liability by liability basis –
  - all liabilities assumed or taken subject to from the partnership,
  - partner assuming or taking subject to liability,
  - whether liability is secured,
  - property securing liability,
  - date of transfer of liability, and
  - date on which liability was incurred.
- ***Partnership Liabilities.*** The Form 1065 should disclose on a liability by liability basis:
  - Amount of liability.
  - Date of liability.
  - Lender.
  - Whether lender is related to the partnership.
  - Whether liability is secured.
  - Whether liability is guaranteed.
    - Identity of guarantor.
    - Date of guarantee.
    - Amount guaranteed.
    - Description of guarantee.
    - Attach copy of instrument under which the guarantee was made.

- Whether liability is a recourse or nonrecourse liability and discussion of basis for classification of the liability.
- Whether amount of liability exceeds fair market value of security.
- Whether liability is recourse or nonrecourse liability.
- Basis for classifying liability as recourse or nonrecourse.
- Basis for determining whether liability is recourse or nonrecourse liability.
- Allocation of liability among partners.
- Explanation of how liability was allocated among partners.
- With respect to each nonrecourse liability,
  - the Section 704(b) minimum gain and each partner's share of this minimum gain,
  - Section 704(c) minimum gain and each partner's share of this minimum gain,
  - the amount of the excess nonrecourse liability element, how the excess nonrecourse liability element is allocated among partners, and the basis for allocating the excess nonrecourse liability
- Where there was any reduction in the principal or interest of the loan other than on account of a payment made by the partnership, and if so,
  - The amount of the reduction.
  - The facts surrounding the reduction.

- The amount of any income that was recognized by the partnership on account of the reduction.
- **Minimum Gain.** The Form 1065 should disclose –
  - each partner's share of minimum gain at the beginning of the taxable year,
  - each partner's share of any increase in minimum gain for the current taxable year,
  - each partner's share of minimum gain at the end of the taxable year, and
  - any increase or reduction in each partner's share of the minimum gain during the year.
- **Minimum Gain Chargeback.** The Form 1065 should disclose, on a partner by partner basis, the amount of any minimum gain chargeback allocation to the partners.
- **Investment Partnership.** The Form 1065 should provide detailed disclosure of –
  - whether the partnership is an investment company under Section 721(b),
  - the relevant computations regarding investment company status and recognition of gain under the investment company rules,
  - list of all assets of the partnership treated as stock and securities under Section 351(e)(1), their fair market values, and how fair market value was determined, and

- the gross fair market value of all assets of the partnership on the last day of the taxable year of the partnership.
- ***Service Partners.*** The Form 1065 should disclose any partners who have received service partnership interests and all relevant details.
  - The Form 1065 should disclose the nature of the service consideration provided.
  - The Form 1065 should disclose how service partnership interest was valued.
  - The Form 1065 should disclose whether gain or loss was recognized on account of service consideration.
  - The Form 1065 should disclose whether the interest received for a service transfer was a capital or profits interest.
  - The Form 1065 should disclose whether the partnership interests issued for service consideration were vested or nonvested. If nonvested, the Form 1065 should disclose the vesting conditions.
  - With respect to each service partnership interest, the Form 1065 should disclose with respect to each service partnership interest:
    - The date of grant of each service partnership interest.
    - Whether the service partnership interest was valued under Revenue Procedure 93-27.
    - Whether the profits interest relates to a substantially certain and predictable stream of income.

- Whether the partner disposes of the profits interest within two years of the grant date.
- Whether the profits interest is a limited partnership interest in a “publicly traded partnership”.
- If relevant, the Form 1065 should provide should disclose all relevant information regarding compliance with Revenue Procedure 2001-43.
- The Form 1065 should have attached any relevant Section 83(b) election that is in effect.
- The Form 1065 should disclose the methodology used in valuing service partnership interests and the results.
- The Form 1065 should disclose whether any partner received a restricted partnership interest and the terms of restriction.
- The Form 1065 should disclose whether any interest in the partnership is an “applicable partnership interest” and any information necessary for determinations under Section 1061.
- The Form 1065 should disclose the necessary partnership information for computations and analysis under Section 199A.
- The Form 1065 should disclose whether –
  - A person (service provider), either in a partner capacity or in anticipation of becoming a partner, performs services

(directly or through its delegate) to or for the benefit of a partnership;

- There is a related direct or indirect allocation and distribution to such service provider; and
- The performance of such services and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person's capacity as a partner.
- The Form 1065 should disclose whether the economic arrangement of the service provider has significant entrepreneurial risk and the nature of the significant entrepreneurial risk.
- The Form 1065 should disclose whether the arrangement involved capped allocations of partnership income and discuss the likelihood that the cap is reasonably expected to apply in most years.
- The Form 1065 should disclose whether the arrangement involves an allocation for one or more years under which the service provider's share of income is reasonably certain.
- The Form 1065 should disclose whether the arrangement involves an allocation of gross income.



- The Form 1065 should disclose whether the arrangement involves an allocation (under a formula or otherwise) that –
  - is predominantly fixed in amount,
  - is reasonably determinable under all the facts and circumstances, or
  - is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider (e.g. if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise).
- The Form 1065 should disclose whether the partnership involves an arrangement in which a service provider waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.
- The Form 1065 should disclose whether the partnership involves an arrangement in which the service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration.
- The Form 1065 should disclose whether the partnership involves an arrangement in which the service provider receives an allocation and

distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment.

- The Form 1065 should disclose whether the partnership involves an arrangement in which the service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third party capacity.
- The Form 1065 should disclose whether the partnership involves an arrangement in which the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution.
- The Form 1065 should disclose whether
  - the partnership involves an arrangement that provides for different allocations or distributions with respect to different services received,
  - the services are provided either by one person or by persons that are related under Sections 707(b) or 267(b), and
  - the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.
- ***Unadmitted Partners.*** The Form 1065 should disclose –

- all unadmitted holders of partnership interests and
- whether the partnership is treating these unadmitted holders as tax partners.
- The Form 1065 should disclose the basis for the classification of the holders as tax partners.
- ***Options to Acquire Partnership Interests.*** The Form 1065 should disclose –
  - whether the partnership has outstanding any options to acquire partnership interests,
  - the holders of those options,
  - the terms of the options, and
  - whether the options have been exercised during the taxable year.
- ***Phantom Partnership Interests.*** The Form 1065 should disclose –
  - whether the partnership has outstanding any phantom partnership interests,
  - the holders of the phantom partnership interests,
  - the terms of the phantom partnership interests, and
  - any payments made during the year with respect to these phantom partnership interests, and
  - date of payment.
- ***Participations.*** The Form 1065 should disclose whether the partnership has outstanding (other than partnership interests) –
  - any participations in the gross income of the partnership, the net income of the partnership, or

modified gross or net income of the partnership – or related to one or more assets of the partnership,

- the holders of the participating interest,
  - the terms of participation,
  - any payments made with respect to the participating interest, and
  - date of payment.
- ***Organization and Syndication Fees.*** The Form 1065 should provide detailed computations showing the treatment of organization and syndication fees.
    - The Form 1065 should provide copies of any election to amortize organizational fees on Form 4562, including:
      - A description of each cost.
      - The amount of each cost (costs of less than \$10 may be aggregated).
      - The month the active business began, (or the month the business was acquired).
      - The number of months in the amortization period (not less than 60).
      - The Form 1065 should disclose a break-down of syndication expenses.
  - ***Section 195 Start-up Expenses.*** The Form 1065 should disclose:
    - Detailed description of all start-up costs.
    - Detailed description of all investigatory expenses.
    - Detailed description of all investigatory expenses.

- Copy of election to amortize start-up expenses.
- ***Cash and Property Distributions.*** The Form 1065 should provide –
  - detailed disclosure of all cash and property distributions to partners,
  - amount of cash distribution,
  - fair market value of property distribution,
  - adjusted tax basis of property distribution,
  - recipient of distribution, and
  - date of distribution.
  - whether gain or loss was recognized on the distribution,
  - if so, computation of the gain or loss,
  - whether the distributee partner acquired the distributed asset with a basis that differed from the partnership's basis in the asset and the computation of the change, and
  - whether the distribution terminates the distributee partner's interest in the partnership.
- ***Property Distributions.*** The Form 1065 should specially report:
  - all property distributions of the partnership to the partner,
  - recipient partner,
  - description of distributed asset,
  - character of the asset under Section 751,

- date of distribution,
  - fair market value on an asset-by-asset basis,
  - adjusted tax basis on an asset-by-asset basis,
  - detail the computations necessary to determine resulting gain and basis computations and Section 734 adjustments, and
  - detail the relevant computations under Section 751(b).
- ***Nonprorata Cash Distributions.*** The Form 1065 should specially report –
    - all nonprorata distributions of cash to the partner (not in accordance with percentage interest),
    - description of distribution transaction,
    - recipients of distribution and amount received in distribution,
    - date of distribution,
    - detail the computations necessary to undertake resulting gain and basis computations and Section 734 adjustments,
    - detail the relevant computations under Section 751(b).
- ***Section 734 Computations.*** The Form 1065 should provide detailed disclosure of Section 734 computations (and related Section 755 computations).
  - ***Section 737 Computations.*** The Form 1065 should provide detailed section 737 computations and the basis for the computations.

- ***Disguised Sales.*** The Form 1065 should provide detailed disclosure of all disguised sales and corresponding computations.
  - In the case of any cash or property distribution to a partner within two years of a property contribution to the partnership by that partner, the Form 1065 should provide an analysis of whether the contribution results in a disguised sale.
- ***Basis of Partners' Partnership Interests.*** The Form 1065 should report –
  - each partner's adjusted tax basis in his partnership interest,
  - detail computation of each partner's basis in his partnership interest, and
  - for each partner, the sum of the partner's tax capital account and the partner's share of minimum gain at the end of the taxable year.
- ***Section 704(c)(1)(A) Computations.*** The Form 1065 should provide detailed disclosure of –
  - Contributions of Section 704(c)(1)(A) assets,
  - Contributing partner,
  - Adjusted basis on an asset-by-asset basis,
  - Fair market value on an asset-by-asset basis,
  - Method of making Section 704(c)(1)(A) computations.
  - Section 704(c)(1)(A) computations on an asset-by-asset basis (including depreciation schedules),

- Any aggregation of assets for Section 704(c)(1)(A) purposes and authority for this aggregation of assets.
- Whether there was a subsequent event that would trigger a taxable gain or loss to the contributing partner on the pre-contribution gain or loss in Section 704(c) property.
- The Form 1065 should disclose all Section 704(c)(1)(A) computations on an asset-by-asset and partner by partner basis.
- The Form 1065 should disclose whether the partnership is using an aggregation method in computing Section 704(c)(1)(A) allocations. The Form 1065 should disclose the authority for this use of an aggregation method.
- ***Fill-up Allocations under Section 704(c)(1)(A).*** The Form 1065 should disclose whether the partnership is aggregation and a fill-up method in computing allocations under Section 704(c)(1)(A).
- ***Section 704(c)(1)(C) Loss Allocations.*** The Form 1065 should specially disclose –
  - Contributions of Section 704(c)(1)(C) assets,
  - Contributing partner,
  - Adjusted basis on an asset-by-asset basis,
  - Fair market value on an asset-by-asset basis,
  - Section 704(c)(1)(C) computations on an asset-by-asset basis,
  - Any aggregation of assets for Section 704(c)(1)(C) purposes and authority for this aggregation of assets.
- ***Section 754 Election.*** The Form 1065 should report



- whether the partnership made a Section 754 election and, if so, should report the date of the election and should attach a copy of the original Section 754 election.
- whether the partnership has revoked the Section 754 election and, if so, should report the date of the revocation and should attach a copy of the original revocation.
- ***Partnership Allocations.*** The Form 1065 should provide detailed disclosure of –
  - all allocations that the partnership believes qualify under substantial economic effect.
  - all allocations that the partnership believes qualify under partners' interests in the partnership.
  - all fill-up allocations.
  - all tiered allocations.
  - all transitory allocations.
  - all shifting allocations.
  - all tracking allocations.
  - all special allocations (including special allocations to service partners).
  - any special allocations to service partners.
- ***Substantial Economic Effect and Partners' Interests in the Partnership.*** The Form 1065 should require the partnership to indicate whether the partnership agreement allocations have substantial economic effect or whether allocations are made in accordance with partners' interests in the partnership.

- ***Substantiality.*** The Form 1065 should provide any partnership computations confirming substantiality of substantial economic effect of partnership allocations.
- ***Partners' Interests in the Partnership.*** If the partnership is relying on partners' interests in the partnership, the Form 1065 should provide detailed explanation of why the partnership believes that allocations satisfy partners' interests in the partnership.
- ***Special Allocations to Retiring Partner.*** The Form 1065 should provide detailed disclosure of special allocations to a retiring partner and effects on the retiring partner's capital account.
- ***Changes to Allocations.*** The Form 1065 should require the partnership to disclose whether there have been changes to allocations during the taxable year and where allocations for the taxable year differ from allocations made during the immediately preceding taxable year.
- **Qualified Income Offset.** The Form 1065 should disclose:
  - the amount of any qualified income offset allocation during the taxable year, and
  - the amount allocated to each partner.
- ***Transitory Tax Credit Allocations.*** The Form 1065 should disclose the allocation of any tax credits where partnership allocations shift between taxable years.

- ***Section 707(a) Payments.*** The Form 1065 should disclose
  - Detailed description of all Section 707(a) payments,
  - Amount of payment,
  - Recipient partner,
  - Date of payment.
- ***Guaranteed Payments.*** The Form 1065 should provide detailed disclosure of all guaranteed payments, including
  - Special disclosure of one-time-only guaranteed payments (such as guaranteed payments to retiring partners and guaranteed payments in connection with the liquidation of the partnership).
  - The Form 1065 should disclose whether the guaranteed payment is made for capital or services.
  - If the guaranteed payment is made for services, the Form 1065 should disclose description of services for which the guaranteed payment is made.
    - The Form 1065 should discuss whether the service provider performs similar services for others.
  - The computational basis for the guaranteed payment.
  - Whether the guaranteed payment must be capitalized, and, if so, to which asset.
- ***Section 751 Events.*** The Form 1065 should provide detailed disclosure of all Section 751 events and detailed Section 751 computations.
- ***Transfers of Partnership Interests.*** The Form 1065 should report:

- all transfers of direct partnership interests during the taxable year,
  - the date of transfer,
  - the transferor partner and transferee,
  - whether the transferee has been admitted as a substituted partner,
  - whether there has been a transfer of a profits interest and, if so, whether the transferor has agreed in writing to exercise any residual rights as a fiduciary for the transferee,
  - whether the partnership has a Section 754 election in effect,
  - identity, address, and TIN of a seller and purchaser,
  - the price of transfer,
  - detailed computations of allocation of Section 743 adjustments,
  - detailed computations of Section 743 adjustments on an asset-by-asset basis, and
  - methodology of determining fair market values of assets for allocating Section 743 adjustments.
- ***Transfers of Indirect Partnership Interests.*** The Form 1065 should specially report corresponding information to the information immediately above should be provided for transfers of interests in upper-tier partnerships that hold interests in the partnership.
  - ***Section 743.*** The Form 1065 should disclose the computation and history of all Section 743 adjustments (and related Section 755 computations), how the

partnership has allocated adjustments among assets, plus a disclosure of events creating these adjustments.

- ***Section 743 Aggregation.*** The Form 1065 should disclose whether the partnership is using an aggregation method in reporting Section 743 adjustments.
- ***Disproportionate Allocations to Retiring Partner.*** The Form 1065 should disclose whether disproportionate allocations of income or loss are being made to retiring partners. The Form 1065 should disclose the details of these allocations.
- ***Varying Interests Rule.*** The Form 1065 should provide detailed computations on the application of the varying interests rule.
- ***Direct and Indirect Partners.*** The Form 1065 should disclose –
  - all direct and indirect partners of the partnership,
  - their addresses,
  - their taxpayer identification numbers,
  - the entity through which they own their partnership interest (if an indirect partner),
  - whether they are flow-through entities.
- ***Association of Partnership Return With Entries in Direct and Indirect Partner Returns.*** There should be coordinating changes in individual and corporate tax returns so that it is possible for the Internal Revenue Service electronically to associate an underlying operating partnership with indirect partners in order to ensure that the indirect partners are

correctly reporting their distributive shares from the operating partnership.

- ***Accounting Fees and Legal Fees.*** The Form 1065 should disclose any legal fees and accounting fees incurred by the partnership during the year.
- ***Opinions of Advisors.*** Any opinions of advisors on which the partnership or a partner intends to rely as a defense against penalties.
- ***Other Fees.*** The Form 1065 should disclose any of these fees incurred during the taxable year (including amount, recipient, transaction to which the fees are attributable, and treatment of the fees for tax purposes) –
  - Investment banker fees.
  - Engagement fees.
  - Consulting fees.
  - Commissions.
  - Advisory fees.
  - Contingent fees.
  - Placement fees.
  - Finders fees.
  - Structuring fees.
  - Origination fees.
  - Brokerage fees.
  - Any contingent transaction fees, including –
    - the amount of the fees,
    - the recipient of the fees, and

- the basis for the determination of the fees.
- ***Tax Shelter Information.*** The Form 1065 should seek the information necessary that are indicators of identified tax shelters and abusive partnership transactions or transactions in which improper reporting is common.
- ***Upper-Tier Partner Tax Information.*** The Form 1065 should disclose necessary information relating to upper-tier partners in order to audit the partnership for multi-tier partnership issues (such as multi-tier basis adjustments, services performed for the partnership by partners of upper-tier entities, and special allocations).
- ***Opportunity Zones.*** The Form 1065 should disclose appropriate information concerning opportunity zones.
- ***Advisor Disclosure.*** The Form 1065 should disclose:
  - the names of all advisors involved in the preparation of the return or giving advice with respect to planning or executing transactions reflected on the return,
  - their PTINs, and
  - the amount paid to each of the advisors for this advice.
- ***Electronic Filing Required.*** The Internal Revenue Service should require electronic filing for all partnership tax returns. This filing should use forms and formats specified by the Internal Revenue Service.
- ***Data Analytic Software.*** The Internal Revenue Service should develop and should employ data analytic software that can analyze the information filed with Form 1065 –

- to determine compliance with the rules of Subchapter K,
- to select returns for audit,
- to confirm tax return computations,
- to identify and to analyze audit issues and noncompliance with the tax law, and
- to ensure consistent audit standards.

This software should identify all major partnership audit issues and should provide audit guidance for the field examiner.

- ***Alternate Partner Identification Numbers.*** The Internal Revenue Service should develop a system of alternative partner identification numbers that can be included on Form 1065 rather than the partners' taxpayer identification numbers, as is currently required. These partner identification numbers also could be used to identify partnership representatives.
- ***Massively Parallel Computer Resources.*** The Internal Revenue Service should acquire massively parallel computing resources to facilitate the use of data analytics to undertake computerized audits for selection of returns for audit and for undertaking the audit as much as possible before the involvement of the field examiner. The field examiner then can concentrate on those issues raised in the computer audit and can limit himself to reviewing the computerized audit results and exploring issues requiring field audit.
- ***Specialized Examiners.*** The Internal Revenue Service should organize local groups of examiners dedicated to



partnership tax examinations. These groups might include subspecialists in particularly difficult areas of partnership taxation (such as partnership allocations).

- ***Dedicated Partnership Examination Groups.*** The Internal Revenue Service should assign all partnership tax audits to dedicated partnership examination groups.
- ***Robust Training for Partnership Examiners.*** The Internal Revenue Service should provide robust training for partnership examiners.
- The Internal Revenue Service should provide partnership examiners with substantial training both from within the Internal Revenue Service and from programs provided by the private sector.
- ***Regularly Monitor Private Sector Tax Programs.*** The Internal Revenue Service should regularly monitor programs on partnership taxation given by the private sector.
- ***Incentive Pay for Partnership Examiners.*** The Internal Revenue Service should provide incentive pay to recruit and to retain partnership tax examiners in order to upgrade and to retain partnership examiners. (Similar proficiency pay may well be desirable for other areas of the Internal Revenue Service.)
- ***Shift Chief Counsel Resources to Partnership Audits.*** The Internal Revenue Service Chief Counsel's office should shift substantial personnel resources from private letter rulings to dedicated legal support of partnership examinations.
- The Internal Revenue Service should assign a Chief Counsel office attorney to support of each substantial

The Honorable Charles P.  
Rettig, Commissioner  
March 16, 2019  
Page 66

partnership tax audit in order to provide legal support for the examiner.

- ***Consider Simplification of Subchapter K.*** Congress should consider broad reform of Subchapter K to simplify its provisions in order to make those provisions more user-friendly to taxpayers and more audit-friendly to Internal Revenue Service examiners.
- ***Consider Limiting Subchapter K to Small Partnerships.*** Congress should consider limiting current Subchapter K to small partnerships with no more than 100 direct and indirect partners.
- ***Consider Creating New Tax Regime for Large Partnerships.*** Congress should consider creating an alternative, simplified tax regime for partnerships with more than 100 direct and indirect partners. This regime might borrow heavily from Subchapter K for many general tax principles, but have simplifying requirements where necessary to ensure compliance and auditability.

I shall respond to any inquiries or shall provide supplementary comments on request.

Very truly yours,

Terence Floyd Cuff

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The Honorable Charles P.  
Rettig, Commissioner  
March 16, 2019  
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The Honorable Charles P.  
Rettig, Commissioner  
March 16, 2019  
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