OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SB/SE),
AREA 4, LOUISVILLE

FROM: Lawrence Schattner, Chief, Branch 3
(Collection, Bankruptcy & Summonses)

SUBJECT: Application of I.R.C. § 7602(c) to Flow-Through Entities

This memorandum is in response to your September 27, 2000 request for field service advice regarding the application of I.R.C. § 7602(c) to flow-through entities, such as TEFRA partnerships, non-TEFRA partnerships, and S corporations. We have coordinated this advice within the office of the Associate Chief Counsel (Procedure and Administration) and the office of the Associate Chief Counsel (Passthroughs and Special Industries). Since section 7602(c) is relevant to all audits involving flow-through entities, we agree that uniform guidance must be provided to examining agents.

ISSUES

1. With respect to a TEFRA partnership, how should reasonable notice in advance be provided to the taxpayer under section 7602(c)(1)?

2. With respect to a TEFRA partnership, what contacts must be reported under section 7602(c)(2).

3. With respect to a non-TEFRA partnership or an S corporation, how should reasonable notice in advance be provided to the taxpayer under section 7602(c)(1)?

4. With respect to a non-TEFRA partnership or an S corporation, what contacts must be reported under section 7602(c)(2).

CONCLUSIONS

1. With respect to a TEFRA partnership, reasonable notice in advance that contacts with third parties may be made should be provided by sending the

appropriate Letter 3164 to the tax matters partner. If the Service is looking at transactions between the partnership and specific, identified, partners, or transactions with third parties for the benefit of specific, identified, partners, which will affect only the separate tax liability of these partners, rather than the tax liability of all of the partners, then those specific partners should also be provided advance notice of any third party contacts relating to such transactions.

2. With respect to a TEFRA partnership, contacts made with any partner are not section 7602(c) contacts because they are considered the equivalent of contacting the partnership. Contacts made with persons other than the partners, or employees of the partnership who are acting within the scope of their duties, are section 7602(c) contacts, and a record of such contacts must be made. Third-party contacts that relate to adjustments that flow through to all the partners should be recorded as contacts with respect to the partnership. Third-party contacts that relate to transactions that will affect only the separate tax liability of specific partners should be recorded as contacts with respect to those specific partners.

3. With respect to a non-TEFRA partnership or S corporation, the person(s) who should be sent advance notice of third party contacts depends on whether the examination of the entity is being conducted at the entity level or as part of the examination of a particular partner or shareholder's return. If the former, reasonable notice in advance that contacts with third parties may be made should be provided by sending the appropriate Letter 3164 to the partnership or S corporation. If the latter, then a Letter 3164 should be sent to the particular partner or shareholder whose return is being examined in addition to the Letter 3164 being sent to the partnership or S corporation.

4. With respect to a non-TEFRA partnership or S corporation, the contacts that must be reported similarly depends on whether the examination of the entity is being conducted at the entity level or as part of the examination of a particular partner or shareholder's return. If the former, contacts made with any partner or shareholder are not section 7602(c) contacts because they are considered the equivalent of contacting the partnership or S corporation. Contacts made with persons other than the partners or shareholders, or employees of the partnership or S corporation, who are acting within the scope of their employment, are section 7602(c) contacts, and a record of such contacts must be made. If the latter, then contacts with any partner or shareholder other than the particular partner or shareholder whose return is being examined should be treated as section 7602(c) contacts with respect to the particular partner or shareholder whose return is being examined. Such contacts would still be considered the equivalent of contacting the partnership or S corporation and, therefore, would not be considered section 7602(c) contacts with respect to the partnership or S corporation.

FACTS

In the course of providing training to Service personnel on the subject of third party contacts under I.R.C. § 7602(c), you have been asked questions about how the statute applies to flow-through entities such as partnerships (TEFRA and non-TEFRA) and S corporations. Currently, these issues are not specifically addressed in the Internal Revenue Manual, the Third Party Contacts Course book that was prepared for Examination CPEs (Catalog Number 85104L), or the Section 7602(c) - Notice of IRS Contact of Third Parties - Revised Procedures, dated November 1, 1999. Because you are seeking general guidance in this area, no specific facts were included in your request.

LAW & ANALYSIS

Under I.R.C. § 7602(c)(1), as enacted by RRA section 3417, an officer or employee of the Service may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of such taxpayer without providing reasonable notice in advance to the taxpayer. The statute also requires the Service to provide the taxpayer with a record of persons contacted both periodically and upon the taxpayer's request. I.R.C. § 7602(c)(2). The congressional intent behind these requirements is to provide taxpayers with the opportunity to come forward with information before third parties are contacted and the means to address any reputational concerns arising from such contacts without impeding the ability of the Service to make those contacts that are necessary to enforce the internal revenue laws. With this intent in mind, we have adopted an interpretative approach to section 7602(c) that balances taxpayers' business and reputational interests, with third parties' privacy interests, and the Service's responsibility to administer the internal revenue laws effectively.

The first requirement of the statute is to provide "reasonable notice" in advance to the taxpayer that contacts with third parties may be made. Letters 3164 have been developed by the Service in order to comply with this requirement. In most field audit situations, either Letter 3164F or Letter 3164G should be used depending upon whether the Service needs to obtain information from third parties or to verify information that the Service has received. The second requirement, providing the taxpayer with a record of persons contacted, is accomplished in part by completing a Form 12175, Third Party Contact Report Form, and submitting it to the appropriate Third Party Contact Coordinator.

1. Application of section 7602(c)(1) to TEFRA partnerships

The audit of TEFRA partnerships is conducted at the partnership (entity) level pursuant to I.R.C. § 6221 through 6234, but any resulting liability is ultimately assessed against the individual partners. The tax matters partner (TMP) is responsible for certain administrative duties during the course of the examination,

including keeping the other partners informed to the extent and in the manner provided by regulations. See I.R.C. § 6223(g). Additionally, under section 6223(a), each partner whose name and address is furnished to the Service is entitled to receive notice of (1) the beginning of an administrative procedure at the partnership level with respect to partnership items, and (2) the final partnership administrative adjustment from any such proceeding.

The issuance of the Letter 3164, the advance notice of potential third party contacts, is not one of the events specified in the regulations that the TMP must provide notice of, or information with respect to, to other partners. See Temp. Treas. Reg. § 301.6223(g)-1T. However, section 7602(c)(1) requires that the Service provide "reasonable notice" in advance to the taxpayer that third party contacts may be made. Thus, the issue with respect to this first requirement under section 7602(c) is what constitutes reasonable notice to the taxpayer.

In a TEFRA partnership proceeding, the tax treatment of partnership items is at issue. Although the respective tax liabilities of the partners may be affected by the results of the partnership-level proceeding, and thus, they are parties to the proceeding, a third party contact relating to the tax treatment of partnership items is not with respect to the determination of the specific tax liability of any of the partners. Hence, the partnership should generally be viewed as the taxpayer for purposes of giving notice under section 7602(c)(1). Notice should be given to the TMP because the TMP is the statutory representative of the partnership and the partners.

Further, when the Service makes third party contacts in connection with a TEFRA partnership proceeding, any section 6103(k)(6) disclosures to third parties will generally be with respect to the partnership or possibly a DBA, e.g., the ABC Partnership or the XYZ Restaurant. It would be unusual to make third party inquiries using the names of the individual investors/partners. To the extent that this does occur, the partner would probably be an employee of the partnership, i.e., actively involved in the conduct of the partnership's business. Under those circumstances, notice to the partnership should suffice as notice to the partner/employee as well.

Finally, as is true with respect to subchapter K, the TEFRA partnership provisions sometimes adopt an entity approach and other times an aggregate approach. For the reasons set forth above, we believe that an entity approach should be adopted for purposes of applying the notice requirements under section 7602(c) to TEFRA partnerships.

For purposes of providing notice under section 7602(c), differentiating between certain classes of partners would be inappropriate. Regardless of the status or position of the partner, the business and reputational interests arising from the making of third party contacts would be the same for all partners. Hence, the

Service should either give notice to all partners or none of the partners (except the TMP). The rules regarding notice partners only apply with respect to the NBAP and the FPAA, neither of which is at issue here. Notifying all partners of third party contacts could be quite burdensome for the Service, particularly if there are a large number of partners, or there are tiers, etc. Additionally, this burden would be exacerbated by the administrative decision to generally provide notice before each separate third party contact, to the extent that different information is being sought or verified. Consequently, this could pose resource problems and would not be an efficient way to administer the internal revenue laws.

In contrast, if the Service is looking at transactions between the partnership and specific partners, or transactions with third parties for the benefit of specific partners that will affect the separate tax liability of those partners and not the tax liability of all of the partners, then the advance notice should also be provided to those specific partners. In this situation, contacts are being made with respect to the determination of the separate tax liabilities of specific, identified, partners. Therefore, the appropriate Letter 3164 should be provided to those partners before any such contacts are made.

2. Application of section 7602(c)(2) to TEFRA partnerships

Contacts made with the partners of a TEFRA partnership are not treated as contacts with persons other than the taxpayer. Since a partnership is not a natural person, it can only speak or act through authorized agents or representatives. Similarly, contacts with a partnership generally must be through a natural person, i.e., an individual. By virtue of their owning a partnership interest, the partners are afforded certain rights and charged with certain responsibilities relating to the partnership by state laws such as the Uniform Partnership Act and the Uniform Limited Partnership Act, as well as under the partnership agreement that they entered into with respect to the specific partnership of which they are a partner. In addition, in TEFRA partnerships, each partner has the right to participate in any administrative proceeding relating to the determination of the proper tax treatment of partnership items at the partnership level. I.R.C. § 6224(a). Hence, the partners may be viewed as being in privity with the partnership, at least for purposes of the administrative tax proceeding. Consequently, a contact made with any partner of a TEFRA partnership should be treated as a contact of the partnership, rather than as a third party contact. Therefore, Service employees need not complete a Form 12175 with respect to contacts made with partners. However, in the situation where the contact relates solely to a particular partner's separate tax liability and not to flow-through items that affect all of the partners, a Form 12175 should be completed concerning that contact even if that contact is made with another partner. For these purposes, the particular partner whose tax liability is at issue should be treated as the taxpayer.

In this regard, contacts made with current officers, employees, or fiduciaries of the taxpayer, who are acting within the scope of their employment or relationship with the taxpayer, are not considered contacts with persons other than the taxpayer. See Prop. Treas. Reg. § 301.7602-2. Thus, it is only necessary to prepare a record of contacts on Form 12175 regarding contacts made with persons other than the partners, or employees of the partnership who are acting within the scope of their employment. Such record must be provided to partners upon their request. The periodic record of contacts may be sent to the TMP, as the statutory representative of the partnership and the partners.

3. Application of section 7602(c)(1) to non-TEFRA partnerships and S corporations

While non-TEFRA partnerships and S corporations file information returns at the entity level, there is no statutorily mandated unified examination at the entity level as prescribed under section 6221 for TEFRA partnerships and under former section 6241 for S corporations. Nonetheless, as a practical matter, both prior to the effective date of TEFRA, as well as with respect to non-TEFRA entities currently, the Service often conducts an examination at the entity level and then applies the results as part of the audit of the tax returns of the partners or shareholders. Other times, however, the Service may examine the entity's return in connection with its examination of the tax return of a particular partner or shareholder. Under either approach there generally is only one examination conducted of the entity's return; a separate examination of the entity's return is not normally conducted with respect to each partner or shareholder whose return is being audited. Notwithstanding the above, unlike a TEFRA partnership proceeding, the partners or shareholders in a non-TEFRA partnership or S corporation do not have the right to participate in any administrative proceedings conducted at the entity level. Moreover, separate proceedings must ultimately be conducted with respect to each partner or shareholder in order for the Service to make any adjustments relating to a non-TEFRA partnership or S corporation. Thus, if the contact is made in the context of an entity-level examination, then the entity should be considered the taxpayer for purposes of section 7602(c)(1). On the other hand, if the contact is made in the context of an examination of a particular partner or shareholder's return, then both that partner or shareholder and the partnership or S corporation should be considered taxpayers for purposes of section 7602(c)(1).

With respect to satisfying the advance notice requirement, there is no TMP to serve as a representative of a non-TEFRA partnership or S corporation, as well as the partners or shareholders. Nonetheless, under state law, the entity generally has an affirmative obligation to keep its partners or shareholders informed about matters regarding the business or affairs of the entity. The Revised Uniform Partnership Act of 1994 provides that each partner and the partnership shall furnish to a partner, and to the legal representative of a deceased partner or partner under legal disability, without demand, any information concerning the partnership's business and affairs reasonably required for the proper exercise of the partner's

rights and duties under the partnership agreement. With respect to S corporations and their shareholders, the corporation has a fiduciary duty to keep shareholders informed concerning matters involving the corporation. Because the entities in question are obligated to inform their beneficial owners as to information that they would reasonably require to carry out their obligations as either partners or shareholders, notice to the entity will be deemed notice to the partners and shareholders for purposes of section 7602(c). Consequently, if an entity-level examination is being conducted, reasonable notice in advance to the partners or shareholders may be provided by sending the appropriate Letter 3164 to the partnership at the partnership address or to the S corporation at the corporation's address. However, if the examination of the entity is being done as part of the examination of a particular partner or shareholder's return, then the Letter 3164 should be sent to that particular partner or shareholder in addition to sending the Letter 3164 to the partnership or S corporation.

4. Application of section 7602(c)(2) to non-TEFRA partnerships and S corporations

Under section 7602(c)(2), the issue is whether a contact with a "person other than the taxpayer" is made when a partner or shareholder is contacted with respect to adjustments to the partnership or S corporation's return that may be flowed through to all of the partners or shareholders. Once again, the answer will depend upon whether the examination of the entity is being conducted at the entity level or as part of the examination of a particular partner or shareholder's return. If an entity-level examination is being conducted, for the reasons discussed in connection with TEFRA partnerships, e.g., entities may only speak or act through natural persons, a contact made with any partner or shareholder should be considered as a contact of the partnership or S corporation, rather than as a contact of a person other than the taxpayer. Contacts with persons other than the partners or shareholders, however, are section 7602(c) contacts, and a record of such contacts must be made and provided to the partners or shareholders upon their request. The periodic reporting requirement under section 7602(c)(2) may be met by sending the record of contacts to the partnership or the S corporation.

On the other hand, if the examination of the entity is being done as part of the examination of a particular partner or shareholder's return, then contacts with any other partner or shareholder should be treated as third party contacts, which must be recorded on a Form 12175 and reported to the partner or shareholder under examination in accordance with the periodic reporting requirement of section 7602(c)(2). In this situation, the record of contacts should be sent to the partner or shareholder whose return is being audited.

If you have any questions, please call (202) 622-3630.