# PARTNERSHIP AUDITS & LITIGATION (TEFRA)

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# PARTNERSHIP AUDITS & LITIGATION (TEFRA)

## I. WHY TEFRA?

A. Partnership items reported on the tax returns of individual partners depend on:

1. The partnership's aggregate income and loss items for the year, determined for the partnership as an entity and reported on its own information return (Form 1065, U.S. Return of Partnership Income); and
2. The partnership's provisions for allocating the aggregate income and loss to individual partners, to be reported on Schedules K-1.

B. Although the **amounts** vary by individual partner, the **determination** of those amounts – both by the partnership in preparing its return and by the IRS during an audit – is very similar for each partner. In most cases, the total partnership-level amounts need be determined only once. Only the individual partner's share of the total amounts differs, and usually that part of the determination is fairly straight-forward.

C. Because partners (rather than the partnership) pay income taxes, there was no provision prior to 1982 for audits at the partnership level. Adjustments were made to each partner's income tax return based on an audit of that partner's return. If a partnership with ten partners had overstated its cost of goods sold, the IRS had to audit each partner individually. This required a significant duplication of effort and caused administrative difficulties.

D. Congress addressed this problem in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. 97-248. Sections 401 – 405 of TEFRA enacted Sections 6046A and 6221 – 6232 and amended Section 6031 of the Internal Revenue Code (the "Code") to address the tax treatment of partnership items. TEFRA made hundreds of other changes to the Code; the description of the new unified partnership audit provisions takes up only 16 pages, less than 4%, of the Bluebook prepared by the Staff of the Joint Committee on Taxation. Yet for tax practitioners today, "TEFRA" is used almost exclusively to refer to these provisions concerning partnership audits and refund claims.

E. Although the TEFRA provisions addressed a real and serious administrative problem, they also created a complex process with many new problems and traps for the unwary.

## II. IMPORTANT DEFINITIONS FOR TEFRA.

A. **Partnership**, I.R.C. § 6231(a)(1)(A): any partnership required to file a return under I.R.C. § 6031(a), that is, Form 1065.

1. I.R.C. § 6031(a) in turn references I.R.C. § 761(a), which defines the term "partnership" to include "a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate."

   (a). Taxpayers can elect, under certain circumstances, to exclude such organizations from Subchapter K and the requirement to file a partnership tax return. The general standard is that the organization "must be availed of (i) for investment purposes only and not for the active conduct of a business, or (ii) for the joint production, extraction or use of property, but not for the purpose of selling services or property produced or extracted. The members of such organization must be able to compute their income without the necessity of computing partnership taxable income." Treas. Reg. § 1.761-2(a)(1). This is common, for example, in oil & gas joint ventures.

   (b). The organization makes the election by filing Form 1065 for the first year with an attached statement. Treas. Reg. § 1.761-2(b)(2)(i). However, the organization may be deemed to have made the election if it shows by the facts and circumstances the members' intention to be excluded from Subchapter K. Treas. Reg. § 1.761-2(b)(2)(ii).

2. The general rule is that the TEFRA audit and litigation procedures are mandatory for adjustments to partnership items. *See* I.R.C. § 6221.

3. I.R.C. § 6231(a)(1)(B) provides a "small partnership" exception. Even if a partnership is required to file Form 1065, the TEFRA unified partnership audit procedures do not apply to "any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner." (A husband and wife are treated as a single partner for purposes of this provision.)

   (a). These are commonly referred to as "non-TEFRA partnerships." However, a small partnership can elect to have the TEFRA provisions apply.
   (b). A partnership with a pass-through partner (e.g., a partnership, trust, S-corporation, or nominee) does not qualify for the "small partnership" exception. A disregarded entity is counted as a partner and causes the partnership to be a TEFRA partnership. Rev. Rul. 2004-88.
   (c). No de minimis exception: The Tax Court has refused to recognize a "de minimis exception" for pass-through partners with nominal interests in the partnership. *Brumbaugh v. Comm'r*, T.C. Memo 2015-65 (partnership not exempt from TEFRA under the small partnership exception even though pass-through partner had only a 0.02% interest).

4. There is a "savings" provision that protects the IRS from making an incorrect determination of whether the TEFRA procedures apply. If the IRS makes a reasonable determination, based on the partnership return for a particular tax year, that the TEFRA procedures either apply or do not apply, that determination will be given effect with respect to the partnership and its partners for that tax year even if the IRS determination was erroneous. I.R.C. § 6231(g).
5. For the 2013 tax year, there were 3,593,917 partnership filings, of which 1,008,000 (28%) were for TEFRA partnerships. A total of 8,454 partnership audits were completed during FY 2013, of which 3,160 (37%) were of TEFRA partnerships. Audits of TEFRA partnerships take significantly more time to complete than audits of non-TEFRA partnerships, and the audit rate of partnerships is significantly lower than the audit rate for C corporations. *See* https://www.treasury.gov/tigta/auditreports/2015reports/201530004fr.pdf.
6. TEFRA does not apply to employment tax audits or worker classification proceedings for entities that are otherwise subject to TEFRA for income tax purposes. The TEFRA partnership procedures are limited to "partnership items," which are items under Subtitle A of the Code, and employment taxes are imposed under Subtitle C. Field Advice 20145001F (release date 12/12/2014).

B. **Partner**, I.R.C. § 6231(a)(2): includes any actual partner in the partnership but also includes "any other person whose income tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership." Thus, "partner" is not restricted to those with a direct interest in the partnership or those who receive a Schedule K-1. This part of the definition is clarified by subsequent definitions of two different types of partners:

1. Pass-through partner, I.R.C. § 6231(a)(9): "a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership with respect to which proceedings under this subchapter are conducted." A disregarded entity is also a pass-through partner. Rev. Rul. 2004-88, 2004-2 C.B. 165.
2. Indirect partner, I.R.C. § 6231(a)(10): "a person holding an interest in a partnership through 1 or more pass-thru partners."
3. Example of tiered structure: Partnership A has two partners, Individual B and Partnership C. Partnership C has two partners, Individual D and S-corporation E. S-corporation E has two owners, Individual F and Individual G. Result: B, C, D, E, F, and G are all "partners" with respect to Partnership A and may have certain rights with respect to audits or refund claims. C and E are pass-through partners. D, E, F, and G are indirect partners.
4. As noted above, a disregarded entity is counted as a partner and causes the partnership to be a TEFRA partnership. The disregarded entity will be a pass-through partner and those owning an interest through it will be indirect partners. Rev. Rul. 2004-88.

C. **Partnership item**, I.R.C. § 6231(a)(3): "with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level."

1. "The critical element is that the partnership needs to make a determination with respect to a matter for the purposes stated . . . ." Treas. Reg. § 301.6231(a)(3)-1(c)(1).
2. This definition is important because a partnership-level proceeding generally can address only partnership items. Other items are determined at the individual partner level.
3. Treas. Reg. § 301.6231(a)(3)-1(a) sets forth several specific items that are treated as partnership items. Generally, these will include all those items that are reported on Form 1065 and Schedules K-1.
4. Partnership items also include various accounting practices and legal and factual determinations that underlie those specific items reported on Form 1065 and Schedules K-1. This would include, for example, the partnership's method of accounting, taxable year, inventory method, and elections. Treas. Reg. § 301.6231(a)(3)-1(b).
5. The partnership's statute of limitations is a partnership item. *Slovacek v. United States*, 36 Fed. Cl. 250 (1996); *Weiner v. United States*, 389 F.3d 152 (5th Cir. 2004); *Kaplan v. United States*, 133 F.3d 469 (7th Cir. 1998).
6. A determination that a partnership lacks economic substance is an adjustment to a partnership item. *United States v. Woods*, 134 S. Ct. 557, 563 (2013).
7. The determination of who is a partner of the partnership is a partnership item. *Blonien v. Comm'r*, 118 T.C. No. 34 (2002). Thus, a putative partner who denies that he is a partner may need to participate in the TEFRA proceedings solely to challenge that status.

D. **Nonpartnership item**, I.R.C. § 6231(a)(4): "an item which is (or is treated as) not a partnership item."

1. These items are not addressed in a partnership-level audit.
2. For example, the amount a partner paid in purchasing a partnership interest from another partner is a nonpartnership item. The partnership doesn't need to know the purchase price for its accounting and return preparation.
3. Partnership items may become nonpartnership items, and therefore not subject to partnership-level proceedings, under certain circumstances. I.R.C. § 6231(b), (c). These primarily involve situations in which it would be more efficient or effective to address the partner's tax liability separately. Examples:

   (a). The IRS decides to treat the items as nonpartnership items. The IRS must notify the partner of this decision.
   (b). The IRS does not allow a partnership-level refund claim filed by an individual partner rather than the TMP (see below) and the partner seeks judicial review of the refund claim.
   (c). The IRS and the partner enter into a settlement agreement with respect to the items.
   (d). The IRS makes a termination assessment or jeopardy assessment against the partner. I.R.C. § 6231(c)(1), (2); Treas. Reg. § 301.6231(c)-4.
   (e). The partner is under criminal investigation. I.R.C. § 6231(c)(1)(B); Treas. Reg. § 301.6231(c)-5.
   (f). The partner is named as a debtor in a bankruptcy proceeding. I.R.C. § 6231(c)(2); Treas. Reg. § 301.6231(c)-7.

E. **Affected item**, I.R.C. § 6231(a)(5); Treas. Reg. § 301.6231(a)(5)-1(a): "any item to the extent such item is affected by a partnership item."

1. These items generally cannot be addressed in a partnership-level audit. Neither can they be included in a partner-level notice of deficiency or litigation unless: (a) based on the partnership return as filed; or (b) delayed until the resolution of the partnership-level proceeding.
2. This includes items on the partner's return that are unrelated to the items on the partnership return but determined in part by those partnership items. For example, the partner's distributive share will affect gross income and therefore the threshold for the medical expense deduction or the limitation of itemized deductions. Treas. Reg. § 301.6231(a)(5)-1(a).
3. The partner's outside basis (to the extent it is based on a nonpartnership item such as the purchase of his partnership interest from another partner) is an affected item. The partner's at-risk amounts, and income or loss from other passive activities are not partnership items. Thus, the loss a partner claims for a partnership is determined in part by his distributive share (a partnership item) and partly by his basis, at-risk, and passive-loss limitations. The loss claimed by the partner is an affected item. Treas. Reg. § 301.6231(a)(5)-1(b), (c), (d).

4. Penalties are also affected items. Treas. Reg. § 301.6231(a)(5)-1(e). However, penalties are subject to special rules concerning the partnership-level proceeding. Although the amount of the penalty cannot be determined in a partnership-level proceeding, because it depends on the partner's tax liability, a partnership-level proceeding can determine whether a penalty applies (before consideration of any partner-level defenses).

   (a). The court can determine "the applicability of any penalty . . . which relates to an adjustment to a partnership item." I.R.C. § 6226(f). Because a determination that a partnership lacks economic substance is an adjustment to a partnership item, the court can determine the applicability of a penalty that relates to a determination that a partnership is a sham. *United States v. Woods*, 134 S. Ct. 557 (2013).

   (b). In *Woods*, involving a Son-of-BOSS tax shelter, the Supreme Court went on to conclude that the determination that the partnership was a sham supported a conclusion that the gross valuation misstatement penalty, I.R.C. § 6662(h), was applicable. The partners' tax returns reflected losses resulting from inflating their outside basis in the partnership interests. The Supreme Court's conclusion was based on the reasoning that a partner cannot have outside basis in a sham partnership. Comparing the basis reported on the partners' return to the correct amount ($0) meets the qualification for a gross valuation misstatement penalty by definition.

   (c). This analysis raises an interesting question concerning the gross valuation misstatement penalty, which was not considered by the parties or the Court. When a court determines that a partnership is a sham, the purported partners should report the activity conducted by the partnership as if it had been entered into directly by the partners. *6611, Ltd. v. Comm'r*, T.C. Memo 2013-49, *P61-62; *Tigers Eye Trading, LLC v. Comm'r*, 138 T.C. 67, 108-09 (2012). What is the proper approach for evaluating a potential gross valuation misstatement penalty?

      (i). The partner's basis in the partnership interest as reported on the partner's return compared to the corrected basis in the partnership interest ($0), or

      (ii). The partner's basis in the partnership interest as reported on the partner's return compared to the partner's basis in the underlying assets.

Under the first approach, adopted by the Supreme Court without considering the alternative, a gross valuation misstatement penalty would still be applicable in the typical Son-of-BOSS case. But it might not in other cases where a court determined that a partnership was a sham.

F. **<u>Computational adjustment</u>**, I.R.C. § 6231(a)(6): "the change in tax liability of a partner which properly reflects the treatment under this subchapter of a partnership item. All adjustments required to apply the results of a proceeding with respect to a partnership under this subchapter to an indirect partner shall be treated as computational adjustments."

1. Computational adjustments are the bridge between the partnership-level proceeding and the partner's tax liability. A final determination that the partnership understated its income by $X, and the allocation of that amount to individual partners, still does not determine or assess additional tax liability for the partners. That is done by a subsequent computational adjustment.

2. There are two categories of computational adjustments.

   (a). Affected items that do not require partner-level determinations. Treas. Reg. § 301.6231(a)(6)-1(a)(2). These would be changes in the partner's tax liability that can be computed mechanically from the partner's return and the results of the partnership-level proceeding. For example, if the partnership-level proceeding resulted in the allocation of additional income to the partner, the partner's tax liability might be easily recalculated by substituting the redetermined partnership items for the partner's previously reported partnership items. If no partner-level determinations are required, the computational adjustment is directly assessed.

   (b). Affected items that do require partner-level determinations. Treas. Reg. § 301.6231(a)(6)-1(a)(3). These can be assessed against the partner only through normal deficiency procedures. However, penalties can be assessed directly and are not subject to deficiency procedures even though they may require partner-level determinations and are subject to partner-level defenses. See discussion below.

## III. BASIC REQUIREMENT OF CONSISTENCY

A. The partnership files a Form 1065, including Schedules K-1 for each partner's distributive share of all of the items of income, deductions, gain, and loss. The partnership is required to send each partner a copy of the Schedule K-1 filed with the IRS.

B. The partner is required to prepare his return consistently with the Schedule K-1. I.R.C. § 6222(a).

1. Alternatively, if the partner believes the Schedule K-1 is incorrect, the partner can prepare his return using the amounts he believes are correct and file Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request, with his return. I.R.C. § 6222(b).
2. If the partner does not file Form 8082 with his return, the IRS may immediately assess, without following deficiency procedures, any additional tax liability that results from a computational adjustment to his tax liability to conform to the partnership return. I.R.C. § 6222(c).

C. If the IRS enters into a settlement agreement with any partner, the IRS shall offer the same terms to any other partner who requests such. I.R.C. § 6224(c)(2). The consistent settlement is not available, of course, to a partner whose partnership items have been converted into nonpartnership items.

## IV. TEFRA AUDIT PROCESS

A. Who can be the Tax Matters Partner ("TMP")? I.R.C. § 6231(a)(7)

1. The purpose of the TMP is to provide the IRS with a single-point liaison during audits and provide a single representative for litigation.
2. General requirement: A general partner in the partnership, at some time during the tax year or when the designation (on the partnership return for that tax year) is made. Treas. Reg. § 301.6231(a)(7)-1(b)(1), (c).
3. General partners, or other partners if all general partners have been disqualified, collectively holding a majority interest in the partnership can designate a TMP after the partnership return is filed. Treas. Reg. § 301.6231(a)(7)-1(e), (f).
4. There are several complex rules in the Regulations concerning designation, resignation, revocation of designation, and termination of designation.
5. If there has been no TMP designation, the TMP is determined as the general partner having the largest profits interest, Treas. Reg. § 301.6231(a)(7)-1(m), or selected by the IRS, Treas. Reg. § 301.6231(a)(7)-1(n) through (r).
6. Special rules apply to a limited liability company treated as a partnership. Treas. Reg. § 301.6231(a)(7)-2.
7. A disregarded entity can be designated as a TMP, if it has authority to bind the partnership under state law. Rev. Rul. 2004-88, 2004-32 I.R.B. 165.
8. The primary consideration behind the complex regulations concerning the TMP is the IRS' need to ensure that there is a single partner to deal with and that the TMP has authority to bind the partnership.

B. Responsibilities during an audit.

1. The IRS is required to give, to all partners whose name and address is furnished, notice of the beginning of an administrative proceeding (audit) at the partnership level and notice of any FPAA resulting from that proceeding. I.R.C. § 6223(a). These partners are referred to as "notice partners." I.R.C. § 6231(a)(8). Notice partners also have certain rights to participation in proceedings and settlements, as described further below.

   (a). The IRS uses the names and addresses shown on the partnership return to identify notice partners. I.R.C. § 6223(c)(1).
   (b). There are exceptions for large partnerships. The IRS need not provide notice to an individual partner if: (a) the partnership has more than 100 partners; and (b) the partner has less than a 1% interest in partnership profits. However, if a group of partners with a 5% aggregate interest request notice and designate one of the members to receive the notice, the IRS must still provide notice to that "notice group." I.R.C. § 6223(b).

(c). The IRS is required to provide notice to indirect partners only if it has the necessary information to do so. I.R.C. § 6223(c)(3). Any partner who is not a notice partner may become a notice partner by filing a statement as described in Treas. Reg. § 301.6223(c)-1(b). If the indirect partner's information is not set forth on the partnership return or in the required statement, the IRS is not required to provide notice even if the information is readily accessible to it. *Walthall v. United States*, 911 F. Supp. 1275 (D.C. Alaska 1995), *aff'd*, 131 F.3d 1289 (9th Cir. 1997).

2. The TMP has the responsibility to keep other partners informed of the proceedings to the extent the IRS is not required to do so. I.R.C. § 6223(g). Thus, the TMP must:

(a). Provide notices of the beginning of an administrative proceeding or of an FPAA to those partners not entitled to notice from the IRS. Treas. Reg. § 301.6223(g)-1(a).
(b). Provide other notices or information, with respect to closing conferences with the auditor, proposed adjustments, the requirements for filing a protest, any Appeals conference, extension of the statute of limitations, the filing of an AAR, the filing of any petition for judicial review, the appeal of any judicial determination, and any final judicial determination. Treas. Reg. § 301.6223(g)-1(b).
(c). The TMP is not required to provide notice to indirect partners unless the indirect partner has been identified to the TMP at least 30 days before notice is required. Treas. Reg. § 301.6223(g)-1(b)(2)(ii).

3. A pass-through partner is required to provide notice to those indirect partners who hold an interest in the partnership through the pass-through partner. Treas. Reg. § 301.6223(h)-1. However, under some circumstances the pass-through partner may not be a notice partner; indirect partners who hold an interest in the source partnership through that pass-through partner might not receive notices.

(a). If the pass-through partner is named as the debtor in a bankruptcy proceeding, that converts the pass-through partner's partnership items into non-partnership items. I.R.C. § 6231(c)(2); Treas. Reg. § 301.6231(c)-7. However, the IRS position is that the bankruptcy does not convert the partnership items of the indirect partners into non-partnership items. CCA 200951035; CCA 201530021. The Ninth Circuit agrees. *Third Dividend/Dardanos Associates v. Comm'r*, 88 F.3d 821 (9th Cir. 1996), *rev'g* T.C. Memo 1994-412 (1994).
(b). If the source partnership is a large partnership and the indirect partner has less than a 1% interest, the large partnership provision of I.R.C. § 6223(b) allows the indirect partner to become a notice partner by forming a notice group. It is not clear whether providing the statement described in Treas. Reg. § 301.6223(c)-1(b) will suffice or whether forming a notice group is the only way to obtain notice partner status.

**Practice tip: An indirect partner in a tiered structure should file the required statement as described in Treas. Reg. § 301.6223(c)-1(b) to become a notice partner and preserve its rights if the pass-through partner declares bankruptcy. But if the source partnership is a large partnership and the indirect partner's interest is less than 1%, the safest approach may be to form a notice group instead.**

4. Collectively, the responsibilities of the IRS, the TMP, and pass-through partners are designed to ensure that essentially all partners receive notice concerning proceedings. However, the administrative proceeding and adjustment are still valid even if partners do not receive the required notice. I.R.C. § 6230(f). *See also Vulcan Oil Technology Partners v. Comm'r*, 110 T.C. 153 (1998), *aff'd sub nom*, 198 F.3d 259 (10th Cir. 1999); *Slovacek v. United States*, 40 Fed. Cl. 828 (1998).

C. The TMP's authority to bind partners.

1. The TMP can generally (see discussion of exceptions below) bind other partners to the extension of the statute of limitations. I.R.C. § 6229(b)(1)(B).
2. The TMP cannot bind notice partners or members of notice groups to a settlement agreement. Even if a partner is neither a notice partner nor a member of a notice group, he can file a statement with the IRS denying the TMP the authority to bind him to a settlement agreement. I.R.C. § 6224(c)(3). The TMP must expressly state in the settlement agreement that it binds the other partners.

3. Notice partners and members of notice groups are never bound by the TMP's settlement agreement unless they are also parties to the agreement. I.R.C. § 6224(c)(1).

D. Statute of Limitations for Assessment

1. Partner-level statute of limitations, I.R.C. § 6501(a): generally, "within 3 years after the return was filed (whether or not such return filed on or after the date prescribed)."

(a). The statute of limitations can be extended by agreement, I.R.C. § 6501(c)(4).
(b). The statute of limitations is based on a six-year period rather than a three-year period for a substantial omission of gross income from the return. Generally, 25% of the gross income reported on the return is considered a substantial omission. I.R.C. § 6501(e).

(i). The IRS has long argued that an overstatement of basis, resulting in an understatement of income, qualifies as a substantial omission of gross income. The issue was litigated extensively from 2005 through 2011, primarily in Son-of-BOSS cases. The Tax Court, Fourth Circuit, and Fifth Circuit held for the taxpayers, while the Seventh, Tenth, D.C. and Federal Circuits held for the government.
(ii). The Supreme Court, in *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012), held that an overstatement of basis does not result in a substantial omission of gross income for purposes of the statute of limitations.
(iii). However, the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. 114-41, 129 Stat. 443, legislatively overturned *Home Concrete* on this point. As a result of the Act's amendments to I.R.C. § 6501(e), an understatement of gross income by reason of an overstatement of basis is considered an omission from gross income for purposes of triggering the six-year statute of limitations. The Act applies to all returns for which the normal assessment period remained open as of the date of its enactment.

(c). The statute of limitations is open indefinitely if the taxpayer fails to file a return, files a false or fraudulent return with the intent to evade tax, or engages in a willful attempt in any manner to defeat or evade tax. I.R.C. § 6501(c)(1) – (3). The fraud exception requires a showing of "intent to evade tax" by the taxpayer. For example, an outside counsel's fraudulent intent would not be sufficient to apply the exception against the partnership that engaged in the transaction. *BASR Partnership v. United States*, 795 F.3d 1338 (Fed. Cir. 2015).

(d). There are also various other exceptions. *See generally* I.R.C. § 6501.
(e). The running of the statute of limitations is suspended after the issuance of a notice of deficiency, for the period during which the Secretary is prohibited from making an assessment, and for 60 days thereafter. I.R.C. § 6503(a)(1).

(i). After the IRS issues a notice of deficiency, the taxpayer has 90 days (or 150 days if the taxpayer is outside the United States) to file a Tax Court petition to redetermine the deficiency. The IRS cannot assess a deficiency until the expiration of the 90-day (or 150-day) period; if the taxpayer files a Tax Court petition, the IRS cannot assess a deficiency until the Tax Court decision has become final. I.R.C. § 6213(a).

2. Partnership-level statute of limitations, I.R.C. § 6229(a): "Except as otherwise provided in this section, the period for assessing any tax imposed by subtitle A with respect to any person which is attributable to any partnership item (or affected item) for a partnership taxable year **shall not expire before** the date which is 3 years after the later of (1) the date on which the partnership return for such taxable year was filed, or (2) the last day for filing such return for such year (determined without regard to extensions)." (emphasis added)

(a). The application of I.R.C. § 6229(a) has been challenged repeatedly in recent years, but it is now well-settled law that it is not a separate statute of limitations. The IRS argued that it merely extends the I.R.C. § 6501 partner-level statute of limitations, based on the "shall not expire before" language. The Tax Court, the Court of Federal Claims, and several Circuit Courts of

Appeal have endorsed the IRS interpretation. *See, e.g., Rhone-Poulenc Surfactants & Specialties, L.P. v. Comm'r*, 114 T.C. 533 (2000); *Curr-Spec Partners, L.P. v. Comm'r*, 579 F.3d 391 (5th Cir. 2009), *cert. den.*, 130 S. Ct. 3321 (2010); *AD Global Fund, LLC v. United States,* 481 F.3d 1351 (Fed. Cir. 2007); *Andantech LLC v. Comm'r*, 331 F.3d 972 (D.C. Cir. 2003); *Schumacher Trading Partners II v. United States*, 72 Fed. Cl. 95 (2006); *Grapevine Imports, Ltd. v. United States*, 71 Fed. Cl. 324 (2006).

(b). The partnership-level statute of limitations can also be extended by agreement. I.R.C. § 6229(b)(1).

(i). Any partner can enter into an agreement with the IRS that extends the statute of limitations for partnership items only with respect to that partner.

(ii). The TMP (or any other person authorized by the partnership in writing to do so) can enter into an agreement with the IRS that extends the statute of limitations for partnership items with respect to all partners.

- ♦ The Tax Court held that apparent authority under state law agency principles is sufficient to give a partner authority to extend the TEFRA statute of limitations even though the signing partner did not have actual authority to do so in the capacity in which he signed an extension agreement. *Summit Vineyard Holdings v. Comm'r*, T.C. Memo 2015-140.
- ♦ Because the TMP owes a fiduciary duty to other partners, an extension may not bind the other partners if the TMP has a severe conflict of interest known to the IRS. *See In re: Martinez*, 564 F.3d 719 (5th Cir. 2009). However, this is a high standard and most challenges by other partners to an extension signed by the TMP have been unsuccessful.

(c). The statute of limitations is based on a six-year period rather than a three-year period for a substantial omission of gross income from the partnership's return. I.R.C. § 6229(c)(2).

(d). If any partner, with the intent to evade tax, signs or participates directly or indirectly in the preparation of a partnership return that includes a false or fraudulent item: (a) the statute of limitations is open indefinitely for that partner with respect to tax attributable to partnership items for that return; and (b) the statute of limitations is based on a six-year period rather than a three-year period for all other partners. I.R.C. § 6229(c)(1).

(i). This provision applies even if the signing/participating partner's intent was to evade taxes for other partners. In *Transpac Drilling Venture v. United States*, 83 F.3d 1410 (Fed. Cir. 1996), the general partner signed the return knowing that it contained false losses and management fees that would reduce the limited partners' taxes. The six-year statute of limitations applied to the limited partners even without evidence that they intended to evade taxes.

(e). The statute of limitations is open indefinitely if no return is filed. I.R.C. § 6229(c)(3).

(f). The running of the statute of limitations is suspended after the issuance of an FPAA, for the period during which a petition for judicial review can be filed under I.R.C. § 6226 (and if a petition is filed, until the decision of the court is final) and for one year thereafter. I.R.C. § 6229(d).

(g). If a partnership item is converted to a nonpartnership item, the period for assessing tax shall not expire earlier than one year after the date the item became a nonpartnership item. I.R.C. § 6229(f)(1).

E. Partners' Right to Participate

1. Any partner has the right to participate in the administrative proceeding. I.R.C. § 6224(a); Treas. Reg. § 301.6224(a)-1(a).
2. However, neither the IRS nor the TMP have obligations to notify the other partners about administrative proceedings other than as discussed above. The other partners normally will have to inform the TMP of their desire to attend meetings. Generally, meetings are scheduled for the

convenience of the IRS and the TMP and arrangements need not be changed simply for the convenience of other partners. Treas. Reg. § 301.6224(a)-1(a).

F. 60-Day Letter

1. Typically, at the conclusion of the audit, the IRS issues an audit report with a "sixty-day letter," which affords the TMP or notice partners 60 days within which to file a protest with Appeals.
2. As with the thirty-day letter in non-TEFRA cases, however, the sixty-day letter is optional at the IRS' discretion. The IRS can instead proceed immediately to issue a notice of final administrative adjustment.

G. Notice of Final Administrative Adjustment ("FPAA") is the equivalent of the statutory notice of deficiency for partnerships.

H. Judicial Review

1. Where can a partner seek redetermination of the FPAA?

(a). As with a non-TEFRA notice of deficiency, the TMP can file a petition in Tax Court within 90 days after the FPAA is mailed. I.R.C. § 6226(a)(1).

(b). If the TMP does not file a petition within 90 days, any notice partner or notice group can file a petition within 60 days after the TMP's 90-day period ends. I.R.C. § 6226(b)(1).

**Practice tip: Because only the TMP and notice partners have the right to contest an FPAA, indirect partners in a tiered structure may want to consider taking the appropriate steps to become notice partners, as described above. Otherwise, the indirect partner is dependent on the pass-through partner to contest the FPAA on behalf of the indirect partner.**

(c). Since the TMP is also a notice partner, the TMP can file a petition for readjustment, in his capacity as a partner other than the TMP, within 150 days after the FPAA is mailed. *Barbados #6, Ltd. v. Comm'r*, 85 T.C. 900 (1985).

(d). The partner (whether TMP or notice partner) can also file in U.S. District Court or the U.S. Court of Federal Claims. I.R.C. § 6226(a)(2), (3).

(i). There is a further jurisdictional requirement for such suits. A readjustment petition can be filed only if the partner filing the petition deposits with the IRS the amount by which the partner's tax liability would increase if the partner's return were made consistent with the partnership return as adjusted by the FPAA. I.R.C. § 6226(e).

(ii). This is similar to the "full payment" rule of *Flora v. United States*, 362 U.S. 145 (1960), for non-TEFRA refund suits, with two notable differences.

- ♦ The petition for readjustment must still be filed within 90 days after the FPAA is mailed to the TMP, instead of allowing the taxpayer to wait to file a refund claim or refund suit within two years after payment.
- ♦ The deposit only covers the potential increased tax liability for that partner rather than all partners.
- ♦ For a pass-through partner, the amount is based on the exposure of the indirect partners who own interests through that pass-through partner. Treas. Reg. § 301.6226(e)-1(a)(1). The IRS interprets this to require a deposit for the total impact on tax liability of the indirect partners, including partnership interests held through other pass-through partners. For example, assume that indirect partner X holds a 5% interest in the source partnership through pass-through partner A and also a holds a 45% interest in the source partnership through pass-through partner B. If A files a petition for readjustment, the required deposit includes not only X's 5% interest owned through A but also X's 45% interest owned through B. The Court of Federal Claims has upheld this interpretation. *Russian Recovery Fund, Ltd. v. United States*, 81 Fed. Cl. 793 (2008).

(e). If multiple petitions are filed, the first action brought in Tax Court shall go forward. If multiple petitions are filed, but none in Tax Court, the first action brought shall go forward. The other actions are dismissed. I.R.C. § 6226(b)(2), (3), (4).

**Practice tip: As noted above, the TMP can file a petition even after the 90-day deadline is missed, by filing a petition in his capacity as a notice partner. This allows more time to prepare the petition, although there is a risk that another notice partner will file first and take priority.**

2. Under non-TEFRA procedures, a taxpayer can choose to not respond to a notice of deficiency, allow the IRS to assess additional tax liability, pay the assessed amount, and then file a refund claim and litigate in District Court or the Court of Federal Claims. That same opportunity is not available under TEFRA procedures. If the partners do not contest the FPAA, any determinations as to partnership items are final. As noted above, however, the partners may still have a choice of forum by paying a bond in order to contest the FPAA in District Court or the Court of Federal Claims.
3. Any person who was a partner at any time during that tax year is allowed to participate in the action, as long as the partner has an interest in the outcome. Thus, if the partnership items at issue have been converted to nonpartnership items with respect to that partner, or the limitations period for assessment against that partner of any tax attributable to the partnership items has expired, the partner can no longer participate. I.R.C. § 6226(c), (d).

**Practice tip: Because I.R.C. § 6226(e) only requires a deposit for the effect of the FPAA on the filing partner's tax liability, the partners can choose a forum other than the Tax Court while minimizing the effect of the deposit requirement. A partner with a small percentage interest in the partnership can file the petition for redetermination of the FPAA. The other partners, under the authority of I.R.C. § 6226(c) and (d), can still participate in the action.**

I. Adjustment to Partners' Tax Liabilities

1. The IRS cannot assess the partner until 150 days after the FPAA was mailed, or, if a petition for redetermination was filed, until the court's decision has become final. I.R.C. § 6225(a).
2. The IRS generally does not have to issue a partner-level notice of deficiency and provide another opportunity to challenge the assessment. I.R.C. § 6230(a)(1).

(a). The IRS mails a notice of computational adjustment to each partner.
(b). The partner has six months after the mailing of that notice to file a claim that the IRS erroneously calculated the computational adjustment. I.R.C. § 6230(c)(1)(A), (2)(A).
(c). The partner can bring a non-TEFRA refund suit (see I.R.C. § 7422) if the claim is not allowed. I.R.C. § 6230(c)(3).
(d). The claim or refund suit cannot challenge any substantive issues. Those must be challenged in a partnership-level petition to redetermine the FPAA.

3. However, for affected items requiring partner-level determinations or items that have become nonpartnership items, the IRS must provide a notice of deficiency and opportunity to file a petition for redetermination, rather than assess the additional tax liability immediately. I.R.C. § 6230(a)(2).
4. The IRS does not have to provide a notice of deficiency with respect to penalties, even though those may require partner-level determinations. I.R.C. § 6230(a)(2)(A)(i). Instead, the IRS can simply assess the penalty amount. The partner must pay the assessed amount and then file a claim that the IRS erroneously imposed the penalty. I.R.C. § 6230(c)(1)(C). Treas. Reg. § 301.6221-1(c). That challenge is limited to partner-level defenses. Treas. Reg. § 301.6221-1(c), (d).

(a). In *United States v. Woods*, 134 S. Ct. 557 (2013), the Supreme Court held that TEFRA gives courts in partnership-level proceedings jurisdiction to determine the applicability of any penalty that could result from an adjustment to a partnership item, even if imposing the penalty would also require determining affected or non-partnership items such as outside basis.

## V. TEFRA REFUND CLAIM PROCESS

A. An Administrative Adjustment Request ("AAR") is the equivalent of a refund claim for partnerships.
B. Statute of Limitations

1. Partner-level statute of limitations for filing refund claims.

(a). General rule, I.R.C. § 6511(a): A claim for credit or refund "shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later."
(b). If the statute of limitations for assessment is extended under I.R.C. § 6501(c)(4), the period for filing a refund claim "shall not expire prior to" six months after the expiration of the assessment period. I.R.C. § 6511(c)(1).
(c). Various special rules for carrybacks, bad debts and worthless securities, foreign tax credit, etc. I.R.C. § 6511.

2. Partnership-level statute of limitations for filing an AAR

(a). General rule, I.R.C. § 6227(a)(1): "A partner may file a request for an administrative adjustment of partnership items for any partnership taxable year at any time which is (1) within 3 years after the later of (A) the date on which the partnership return for such year is filed, or (B) the last day for filing the partnership return for such year (determined without regard to extensions) . . . ."
(b). But an AAR cannot be filed after the IRS mails an FPAA to the TMP for that tax year. I.R.C. § 6227(a)(2).

(i). The TMP or another partner may file a petition for readjustment of the FPAA, as discussed above.
(ii). The court has the jurisdiction to determine all partnership items, I.R.C. § 6226(f), so the taxpayer can litigate items totally unrelated to the FPAA. Treas. Reg. § 301.6226(f)-1(a) ("Thus, the review is not limited to the items adjusted in the notice.")
(iii). This is more cumbersome than an administrative resolution of the issue, but generally can achieve the same results as by filing an AAR. The drawbacks:

- It comes with quicker deadlines. The petition to redetermine an FPAA must be filed within ninety days after the FPAA is issued. An AAR can be filed within three years after the partnership return was filed or was required to be filed, whichever is later The taxpayer then has a longer period of time to file a petition for judicial review when the AAR is not allowed.
- It is the only alternative once the FPAA is issued. If the partners don't challenge the FPAA, they can no longer seek a favorable adjustment through an AAR.

**Practice tip: The partners should review the partnership return carefully for potential favorable adjustments as soon as a partnership administrative proceeding begins. If the auditor is not willing to incorporate such adjustments into the FPAA, the partners need to be prepared to include those items in a petition for a redetermination of the FPAA, even if they would otherwise concede all of the adjustments in the FPAA.**

(c). If the statute of limitations for assessment of partnership items is extended under I.R.C. § 6229(b), then the period for filing an AAR is extended for the period during which an assessment may be made and for 6 months thereafter. I.R.C. § 6227(b).
(d). The statute of limitations for filing an AAR does not work like the statute of limitations for assessments related to partnership items. The government can make an assessment while either the partner-level or partnership-level periods are open. The period for filing an AAR, however, is apparently determined solely by I.R.C. § 6227.

(i). I.R.C. § 6227 does not include the same "shall not expire before" language that courts relied on when interpreting the interaction of I.R.C. §§ 6501 and 6229. See discussion above.

(ii). The IRS has never addressed the interaction of the partner-level and the partnership-level limitations periods in the context of AARs.

(iii). The only court to date that has considered the issue is *McFerrin v. United States*, 492 F. Supp. 2d 695 (S.D. Tex. 2007). The court did not directly address the issue, but its holding that the partnership's amended return was untimely because it was filed more than three years after the partnership's return was filed (but less than three years after the partner's return was filed) implies that I.R.C. § 6227 is a stand-alone statute of limitations.

3. Partnership-level statute of limitations for allowing a refund.

(a). Unlike non-TEFRA procedures, the TEFRA provisions include a separate statute of limitations that is relevant to refunds.

(b). I.R.C. § 6230(d)(1) limits when the IRS may allow partners credits or refunds of overpayments attributable to partnership items. Generally, no such credits or refunds "shall be allowed or made to any partner after the expiration of the period of limitation prescribed in section 6229 with respect to such partner for assessment of any tax attributable to such item." (Exceptions to the general rule are included in I.R.C. § 6230(c), (d)(2), and (d)(3).)

(c). This is most likely intended for the IRS to allow refunds even without AARs, for example, as the result of a computational adjustment, an audit, or resolution of an FPAA. *See* I.R.C. § 6230(d)(5) (overpayments attributable to partnership items or affected items "to the extent practicable . . . shall be allowed or made without any requirement that the partner file a claim therefore.").

(d). The *McFerrin* taxpayers argued that I.R.C. § 6230(d)(1) is based on I.R.C. § 6229 and therefore on I.R.C. § 6501. Therefore, since the partner-level statute of limitations for assessment was still open, the partnership amended returns should be considered timely. The court rejected the argument, although its analysis was not persuasive.

(e). The IRS has stated in Field Service Advice that the statute extension theory might apply, so that the IRS could make a refund. However, the IRS concluded that this would be at its discretion. "The taxpayers probably have no affirmative right to seek a refund . . . ." FSA 1999-871. Whether the statute extension theory applies to I.R.C. § 6230(d)(1), however, is not a settled issue.

**Practice tip: Given the minimal guidance and lack of binding precedent in this area, the tax practitioner should consider whether it is possible (and worthwhile) to file an AAR even after the I.R.C. § 6227 period has expired and argue that the AAR is still timely based on the "statute extension" theory or I.R.C. § 6230(d)(1).**

C. Who Can File an AAR?

1. The TMP can file an AAR on behalf of the partnership. I.R.C. § 6227(c).

(a). The TMP files an amended Form 1065, with Form 8082 (Notice of Inconsistent Treatment or Administrative Adjustment Request) with the service center where the partnership's return was originally filed. The TMP does not enter any amounts on Form 1065 itself. The TMP does, however, submit amended Schedules K-1 for each partner.

(b). Under appropriate circumstances, a disregarded entity can be the TMP. Rev. Rul. 2004-88, 2004-2 C.B. 165. Accordingly, it appears that a disregarded entity can file an AAR on behalf of the partnership.

(c). The TMP can request "substituted return" treatment. I.R.C. § 6227(c)(1). This allows the IRS to treat any changes as corrections of mathematical or clerical errors on the partnership return.

(i). Assessments of individual partners' tax liabilities can be made without a partnership-level proceeding. I.R.C. § 6230(b)(1).

(ii). However, each partner has 60 days after receiving the notice of correction to request that the IRS not make such correction with respect to that partner. I.R.C. § 6230(b)(2). Thus, a TMP cannot unilaterally force a deficiency on other partners, who may disagree with the AAR, without allowing them an opportunity to contest the adjustments.

**Practice tip: The IRS generally will not treat an AAR as a substituted return unless the AAR results in additional tax to some partners and no refunds to any partner. Further, requesting substituted return treatment can obviously harm relations with other partners, even though they have an opportunity to contest the adjustment. A request to treat an AAR as a substituted return will rarely be appropriate**.

(d). If the IRS does not treat the AAR as a substituted return, it can conduct a partnership-level audit, allow credits or refunds from the AAR to all partners (except with respect to partners for whom the item has become a nonpartnership item), or simply do nothing. I.R.C. § 6227(c)(2).

2. Any partner can file an AAR on his own behalf. I.R.C. § 6226(d).

(a). The partner other than a TMP files an AAR in duplicate:

(i). The partner's own amended return (e.g., Form 1040X or 1120X) with Form 8082 attached.
(ii). A copy of Form 8082 is filed with the service center where the partnership's return is filed.

(b). The partner can file an AAR even if the TMP has already filed an AAR for the same tax year. FSA 587 (Feb. 2, 1993); CCA 200908031 (Nov. 5, 2008). Normally, the IRS will disallow the individual partner's AAR, but merely filing the AAR may help preserve the partner's rights. See discussion below.
(c). The IRS can conduct a partnership-level audit, notify the partner that all of his partnership items for that partnership tax year will be treated as nonpartnership items (allowing him to proceed under non-TEFRA procedures), or process the request as a claim for refund with respect to nonpartnership items. I.R.C. § 6227(d).
(d). An indirect partner is a "partner" for purposes of this provision and therefore can file an AAR. "The indirect partner must show how the source partnership items flow through the tier pass-through partner before getting to his Form 1040 in order for us to process the request – the burden is on him to show how he is entitled to a refund. The claim can be denied if he does not do so." CCA 201125039 (June 9, 2011).

D. Judicial Review

1. If the IRS does not allow in full an AAR filed by the TMP, the TMP can file a petition for judicial review. I.R.C. § 6228(a)(1).

(a). The TMP can file the petition with the Tax Court, District Court, or the Court of Federal Claims.
(b). The petition must be filed at least six months, but no later than two years, after filing the AAR. I.R.C. § 6228(a)(2)(A). This period can be extended by agreement. I.R.C. § 6228(a)(2)(D).

**Practice tip: Non-TEFRA refund suits must be filed no later than two years after the refund claim is <u>disallowed</u>. A petition for judicial review of an AAR must be filed no later than two years after the AAR is <u>filed</u>. The statute of limitations does not remain open indefinitely if the IRS does not formally disallow the AAR, as it does with a non-TEFRA refund claim. In e-mail advice, the office of Chief Counsel recognized that taxpayers may be unaware that the rule is different and suggested that the IRS inform the taxpayer as a courtesy. However, there is no standard policy. As a result, unfamiliarity with the statutes of limitation could result in forfeiting the partner's claim.**

(c). A petition for judicial review of an AAR cannot be filed after the IRS mails either a notice of the beginning of an administrative proceeding, I.R.C. § 6228(a)(2)(B), or an FPAA, I.R.C. § 6228(a)(3).

(i). If the IRS issues an FPAA, the partners can seek a redetermination concerning the refund items in a petition for readjustment. See discussion above.
(ii). What happens if the IRS mails a notice of the beginning of an administrative proceeding, thus prohibiting a petition for judicial review of an AAR, but never issues an FPAA? I.R.C. § 6228(a)(2)(C): If no FPAA is mailed before the expiration of the statute of limitations for assessment of tax attributable to partnership items:

- The prohibition against filing a petition for judicial review of an AAR after the issuance of a notice of the beginning of an administrative proceeding is lifted; and
- The period for filing the petition for judicial review does not expire before the date six months after the statute of limitations for assessment expired.

(iii). But this savings clause does not apply if the notice of the beginning of an administrative proceeding is issued after the statute of limitations for filing a petition for judicial review has expired. In *Atlantic Richfield Co. v. Treasury*, 79 A.F.T.R.2d (RIA) 97-585 (D.D.C. 1996), the statute of limitations for filing an AAR expired before the IRS began auditing the partnership. The IRS identified taxpayer-favorable adjustments totaling $800 million but declined to issue an FPAA. The taxpayer sought an order compelling the IRS to issue a "no change" FPAA, to permit a petition for readjustment to claim the additional deductions and tax credits. The court denied the motion for a temporary restraining order.

(d). As with petitions for readjustment of an FPAA, the other partners are allowed to participate in the action as long as they have an interest in the outcome. I.R.C. § 6228(a)(4).

2. If a partner files an AAR on his own behalf, which the IRS does not allow in full, and the TMP does not file a petition for judicial review under I.R.C. § 6228(a)(1), the partner can file a regular refund suit under I.R.C. § 7422. I.R.C. § 6228(b)(2)(A).

(a). The partnership items are then treated as nonpartnership items with respect to that partner. I.R.C. § 6228(b)(2)(A)(ii). Thus, the partner's suit is a regular refund suit rather than a petition under the TEFRA procedures.

(b). The period for filing such an action is at least six months, and not later than two years, after the AAR was filed. I.R.C. § 6228(b)(2)(B)(i). This period can be extended by agreement. I.R.C. § 6228(b)(2)(B)(ii).

(c). As with petitions by the TMP, this action cannot be filed after the IRS mails a notice of the beginning of a partnership proceeding for that tax year. I.R.C. § 6228(b)(2)(C).

(i). If the IRS issues an FPAA, the AAR items can be addressed as part of that process.

(ii). If the IRS doesn't issue an FPAA, the prohibition against filing a petition for judicial review of the AAR, after the IRS mails notice of the beginning of a partnership proceeding, is lifted and the period for filing the petition does not expire before the date six months after the expiration of the statute of limitations for assessment. I.R.C. § 6228(b)(2)(D).

**Practice tip: If the TMP files an AAR but chooses not to file a petition for judicial review, the other partners have no recourse. (This differs from the situation with respect to an FPAA, where any partner can file a petition for readjustment if the TMP does not.) The TMP has fiduciary obligations to the other partners and in most cases will protect their rights by filing for judicial review. However, if the partner files his own AAR, he will be able to file a refund suit if the TMP does not act. Each partner should consider whether to file their own AAR to protect their rights.**

E. Alternative Methods of Recovery

1. As noted above, if the statute of limitations for filing an AAR or petition for judicial review have expired, but the I.R.C. § 6230(d)(1) period is still open, the partner can request the IRS issue a credit or refund pursuant to I.R.C. § 6230(d)(5). FSA 1999-871.

2. Some potential refund items might relate to transactions between the partnership and the partner or a related party in which the partner also has an interest. If so, there may be an opportunity to apply equitable recoupment.

(a). Although equitable recoupment normally applies when a single transaction is subject to two taxes imposed on the same taxpayer, it has been extended in some instances to separate taxpayers "where there is a clear identify of interests between them, such that the benefits and detriments to one party inure exclusively to the other." TAM 9708002.

(b). At least one court has allowed equitable recoupment when there was not a complete identity of interests. *Estate of Buder v. United States*, 372 F. Supp.2d 1145 (E.D. Mo. 2005), *aff'd*, 436 F.3d 936 (8th Cir. 2006).

3. Another possible approach, if refund items relate to transactions between the partnership and the partner, is the mitigation provisions of the Code, I.R.C. §§ 1311-1314.

   (a). When inconsistent positions are taken on the returns of two different taxpayers rather than two different tax years for the same taxpayer, mitigation is available only when the two taxpayers are related. I.R.C. § 1313(c)(6) includes "partner" in the definition of related taxpayers. That is normally interpreted to address the relationship between two partners rather than between a partnership and one of its partners. *E.g., Great Falls Nat'l Bank v. United States,* 388 F. Supp. 577 (D.C. Mont. 1975). It is not clear whether mitigation would be available in situations like this.

**Practice tip: If the deadline for filing an AAR or a petition for judicial review has passed, investigate alternative methods of recovery.**

## VI. TEFRA – PROBLEMS AND FUTURE

A. The partnership audit process has long been considered problematic. As far back as 1980, the General Accounting Office recommended that the IRS reconsider its strategy for partnership returns. The IRS completed a comprehensive partnership compliance study in 1990. LB&I and SB/SE divisions initiated a strategy in July 2012 to improve the partnership audit process. Significant improvements have been made over the years but more are needed, as several recent government studies and legislative proposals indicate.

B. On March 19, 2014, the the Government Accountability Office issued a report entitled, *Large Partnerships: Characteristics of Population and IRS Audits*. (The full report is available at http://www.gao.gov/assets/670/661772.pdf.) For purposes of this report, the GAO defined large partnerships as those partnerships that reported having 100 or more direct partners and $100 million or more in assets. Key highlights from the GAO report include the following findings:

   1. The Scope of Partnerships: In tax year 2011, nearly 3.3 million partnerships accounted for $20.6 trillion in assets and $580.9 billion in total net income.
   2. Large Partnerships are Growing: The number of large partnerships with 100 or more direct partners and $100 million or more in assets increased from 720 in tax year 2002 to 2,226 in tax year 2011. Large partnerships also increased in terms of the average number of direct partners and average asset size.
   3. Completed Audits: The number of completed field audits of large partnership returns increased from 11 in fiscal year 2007 to 31 in fiscal year 2013. IRS audits closed through its campus function increased from 42 to 143 over the same period.
   4. No-Change Audits: The percentage of IRS partnership audits that resulted in no change to the taxpayer's return was 52 percent for campus function audits and 45 percent for field audits in fiscal year 2013.

C. On July 22, 2014, the Government Accountability Office issued a report entitled, *Large Partnerships: Growing Population and Complexity Hinder Effective IRS Audits*. (The full report is available at http://www.gao.gov/assets/670/664917.pdf.) The GAO classified large partnerships for purposes of this report as those with 100 or more direct and indirect partners and $100 million or more in assets. Key highlights from the GAO report include the following findings:

   1. Growth in Large Partnerships: From tax years 2002 to 2011, the number of large partnerships more than tripled. According to IRS data, there were more than 10,000 large partnerships (as defined in the study) in 2011. A majority had more than 1,000 direct and indirect partners although hundreds had more than 100,000. A majority also had six or more tiers.

2. Partnerships and C Corporations are Moving in Different Directions: Businesses with U.S. tax obligations are increasingly adopting more complex structures, shifting away from C corporations and moving towards pass-through entities, such as partnerships. Between tax years 2002 and 2010, the number of businesses organized as a partnership rose 45 percent from about 2.2 million to 3.2 million. In contrast, the number of C corporations decreased about 14 percent from 1.9 million to 1.6 million over the same time period.
3. Industries: Large partnerships, especially those in higher asset brackets, are primarily involved in the finance and insurance sectors. For example, in 2011, 73 percent of large partnerships reported being involved in the finance and insurance sector and the majority of large partnerships that reported $1 billion or more in assets were in this sector. IRS data also showed that almost 50 percent of large partnerships with 100,000 or more direct and indirect partners reported being in the finance and insurance sector.
4. Audit Rate Disparities: The IRS audits relatively few large partnerships—0.8 percent in fiscal year 2012 compared to 27.1 percent for large corporations. Of the audits that were done, about two-thirds resulted in no change to the partnership's reported net income. The remaining one-third resulted in an average audit adjustment to net income of $1.9 million.

D. On September 18, 2014, the Government Accountability Office issued a report on problems associated with auditing large partnerships. (The full report is available at http://www.gao.gov/assets/670/665886.pdf.) For purposes of the report, the GAO defined a "large partnership" as a partnership that reported having 100 or more direct and indirect partners and $100 million or more in assets. Key highlights from the GAO report include the following findings:

1. There has been a significant shift away from C corporations and to pass-through entities such as partnerships. Between 2002 and 2011, the number of partnership returns increased by 47% to 3.3 million, while the number of C corporation returns decreased by 22% to 1.6 million. The number of large partnerships grew even faster during this period, more than tripling to more than 10,099. They held trillions of dollars of assets.
2. The complexity of large partnerships, the number of partners, and the frequent use of tiered structures create a number of enforcement challenges. For example:

   (a). It is often difficult to identify which entity in a tiered structure is generating the income or losses.
   (b). Complex structures could mask tax compliance.
   (c). The interaction of TEFRA procedures with increasingly complex partnership structures make it difficult to complete the audit within the statute of limitations.
   (d). It can be difficult to identify a qualified TMP for the partnership, if not designated on the partnership tax return.
   (e). Linking the partnership return to the partners' returns and determining computational adjustments for each partner are largely manual processes. This can be very difficult for large partnerships, particularly if the partnership agreements include special allocations that differ from the ownership interest reported on Schedule K-1. Passing audit adjustments through to partners is costly and very time consuming; dividing them among hundreds or thousands of partnerships may result in amounts too small to be worth dealing with.

      (i). Although linking the partnership return to the partners' returns requires manual intervention, the linkage is recorded in the Partnership Control System (PCS) database, which is used to generate notices and flow through adjustments. The database may be able to accommodate only a limited number of linkages, which may limit the number of widely held, multi-tiered partnerships that the IRS can audit. Elliott, "Audit Proof? How Hedge Funds, PE Funds, and PTPs Escape the IRS," 2012 TNT 141-1.
      (ii). The Office of Chief Counsel recently issued legal advice concluding that the IRS is not required to link all partners on PCS and is not required to notify a partner if it decides not to pass through partnership-level adjustments to that particular partner. AM 2015-003. This would allow the IRS to limit linkage to partners with a significant interest, alleviate the limitations of the system, and improve the efficiency of partnership audits.

3. The IRS audits few large, complex partnerships. Most of the audits resulted in no change to reported income or losses and others resulted in a minimal aggregate amount of adjustments.

E. On March 18, 2015, the Treasury Inspector General for Tax Administration (TIGTA) issued a report on additional improvements needed to measure the success and productivity of the partnership audit process. (The full report is available at https://www.treasury.gov/tigta/auditreports/2015reports/201530004fr.pdf.) Key highlights from the report include the following findings:

1. Partnership filings have been steadily increasing, and TEFRA partnerships have grown at an even faster rate.
2. The IRS does not know the extent of partnership tax compliance. Although partnership audits have resulted in billions of dollars in partnership audit adjustments, the IRS does not know how much additional tax is ultimately assessed to the taxable partners as a result of such adjustments to the partnership returns.
3. TIGTA is concerned with the lack of adequate performance measures and the fact that it has been more than 20 years since the IRS conducted a comprehensive compliance study on partnerships.
4. As of Tax Year 2011, the number of partnerships and direct partners totaled about 3.3 million and 24.4 million, respectively. These partnerships reported assets of $20.6 trillion and net income of $580.9 billion.
5. Between Fiscal Years (FY) 2010 and 2013, field examiners from the Large Business and International (LB&I) and the SB/SE Divisions completed 31,044 partnership audits, of which 11,123 (or about 36 percent) were TEFRA audits. The 11,123 TEFRA audits also represent approximately 1 percent of the 954,970 audits completed by the LB&I and SB/SE Divisions between FYs 2010 and 2013. Although this is a very small percentage of the total number of LB&I and SB/SE Division audits completed, the resources used to complete the TEFRA audits are substantial. For example, the number of hours charged to TEFRA and non-TEFRA audits that were closed during FYs 2010 through 2013 was approximately 2.47 million hours, and of this, approximately 1.57 million hours (about 63.5 percent) were devoted to TEFRA audits.
6. During FYs 2010 through 2013, 43 percent of the partnership audits closed resulted in a no-change. However, for the same time period, the no-change rate for TEFRA audits was higher (53 percent) than non-TEFRA audits (37 percent).
7. Approximately $38.2 billion (91 percent) of the $41.8 billion in partnership audit adjustments were from the LB&I and SB/SE Divisions' audits involving TEFRA partnerships.
8. The IRS uniformly applies an assessment tolerance to each partner for assessing partnership adjustments. Therefore, if the IRS determines that a potential assessment will fall below tolerance, the assessment will not be made. The IRS does not publically release the specific tolerance level.

F. The President's FY 2016 budget proposal included a proposal to streamline audit and adjustment procedures.

1. The Treasury's General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (known as the "Green Book") found that the present TEFRA partnership audit and adjustment procedures for large partnerships remain inefficient and more complex than those applicable to other large entities.
2. The President's Fiscal Year 2016 budget proposal included a proposal to repeal TEFRA and the electing large partnerships (ELP) procedure and would instead mandate new simplified partnership procedures (SPP) for any partnership (1) that has 100 or more direct partners in the aggregate during the taxable year to which the adjustment relates or (2) that has at least one partner that is another partnership, estate, trust, S corporation, nominee, or similar person ("pass-through partner") at any time during the taxable year to which the adjustment relates. Under the proposal, a partnership subject to the SPP regime because it has at least one pass-through partner could elect out of the SPP regime if the partnership can demonstrate that the total number of direct and indirect partners is less than 100 in the aggregate during the taxable year to which the adjustment relates, in which case each partner would be subject to separate deficiency proceedings.
3. Under the SPP regime, the IRS would audit the partnership and make adjustments at the partnership level that flow through to the partners who held their partnership interest during the year to which the

adjustment relates. Direct partners that are pass-through partners would be responsible for paying the tax on behalf of their owners.

4. Unlike under the current TEFRA partnership rules, under the SPP regime only the partnership could request a refund and the partners would not have the right to participate in partnership-level administrative proceedings.
5. Under the proposed SPP regime, the IRS would not need to give notice to partners of the beginning of an administrative proceeding or of a final adjustment. Instead, a notice of partnership adjustments would be sent to the source partnership, and only the partnership, through an authorized person, could participate in partnership proceedings. Only a U.S. individual could be designated by the partnership to act on its behalf.
6. Under the SPP regime, partners would be required to report partnership items consistently with the partnership return, unless the partner notified the IRS of the inconsistent treatment. Similar to the rules under TEFRA, if a partner failed to notify the IRS of inconsistent treatment, the IRS could immediately assess the partner under its math error authority. The SPP regime, however, would require the IRS to audit the partnership in order to assess a partner who has filed a notice of inconsistent filing. This differs from the TEFRA rules which currently allow the IRS to issue a separate notice of deficiency to the partner who has filed a notice of inconsistent treatment.

G. In February 2014, the House Ways and Means Committee issued an alternative proposal that would completely replace the TEFRA audit procedures. The proposal would expand the number of partnerships subject to revised procedures and the IRS could assess the partnership itself, which would have to pay any additional tax.

1. Under the proposed legislation, the current TEFRA and ELP rules would be repealed, and the partnership audit rules would be streamlined into a single set of rules for auditing partnerships and their partners at the partnership level. Similar to the current TEFRA rule excluding partnerships with fewer than 10 partners, the legislation would permit smaller partnerships with 100 or fewer partners (other than partners that generally are passthrough entities themselves) to opt out of the new rules, in which case the partnership and partners would be audited under the general rules applicable to individual taxpayers
2. Under the proposed legislation's streamlined audit approach, any IRS adjustments would be taken into account by the partnership (not the individual partners) in the year that the audit or any judicial review is completed (the "adjustment year"). Partnerships would have the option of demonstrating that the adjustment would be lower if the adjustment included partner-level information from the reviewed year rather than imputed amounts based solely on the partnership's information in such year. A partnership would also have the option of initiating an adjustment for a reviewed year with the adjustment taken into account in the adjustment year.