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TEFRA Audits and Refund Claims

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TEFRA Audits and Refund Claims

- 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 straightforward.
 - C. Because partners (rather than the partnership) pay 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 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.

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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. 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.) These are commonly referred to as “non-TEFRA partnerships.” However, a small partnership can elect to have the TEFRA provisions apply.
 3. 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).

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- 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-thru 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-thru 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-thru partners. D, E, F, and G are indirect partners.
- 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. This definition is important because a partnership-level proceeding generally can address only partnership items. Other items are determined at the individual partner level.
 2. Treas. Reg. § 301.6231(a)(3)-1(a) sets forth several specific items. Generally, these will include all those items that are reported on Form 1065 and Schedules K-1.
 3. 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).

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4. “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).
 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).
- 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.

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- 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).
- F. **Computational adjustment**, 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.

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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 computation 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.
 - (i). However, penalties can be assessed directly and are not subject to deficiency procedures. See discussion below.

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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 include with his return Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request. 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.

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IV. TEFRA Audit Process

A. Responsibility of Tax Matters Partner (“TMP”)

1. Who can be the TMP? I.R.C. § 6231(a)(7)

- (a). The purpose of the TMP is to provide the IRS with a single-point liaison during audits and provide a single representative for litigation.
- (b). 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).
- (c). 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).
- (d). There are several complex rules in the Regulations concerning designation, resignation, revocation of designation, and termination of designation.
- (e). 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).
- (f). Special rules apply to a limited liability company treated as a partnership. Treas. Reg. § 301.6231(a)(7)-2.
- (g). A disregarded entity can be designated as a TMP. Rev. Rul. 2004-88, 2004-32 I.R.B. 165.
- (h). 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.

2. Responsibilities during an audit.

- (a). 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).

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- (i). The IRS uses the names and addresses shown on the partnership return to identify notice partners. I.R.C. § 6223(c)(1).
 - (ii). 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).
 - (iii). 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).
- (b). 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:
- (i). 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).
 - (ii). 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).
 - (iii). 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).
- (c). A pass-thru partner is required to provide notice to those indirect partners who hold an interest in the partnership through the pass-thru partner. Treas. Reg. § 301.6223(h)-1.
- (d). Collectively, the responsibilities of the IRS, the TMP, and pass-thru 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*

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sub nom, 198 F.3d 259 (10th Cir. 1999); *Slovacek v. United States*, 40 Fed. Cl. 828 (1998).

3. The TMP's authority to bind partners.
 - (a). 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).
 - (b). The TMP can bind another partner to a settlement agreement only if the partner is neither a notice partner nor a member of a notice group, and the partner has not denied that authority to the TMP by filing a statement with the IRS. I.R.C. § 6224(c)(3). The TMP must expressly state in the agreement that it binds the other partners.
 - (i). Other partners are bound by a settlement agreement only if they are parties to the agreement. I.R.C. § 6224(c)(1).

B. 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 contends that an overstatement of basis, resulting in an understatement of income, qualifies as a substantial omission of gross income. This is an expansive reading of the six-year statute and was used frequently in recent years in Son-of-BOSS cases.
 - (ii). The Supreme Court, interpreting the 1939 Code, held that an overstatement of basis is not an omission of gross income. *Colony, Inc. v. Comm'r*, 357 U.S. 28 (1958). In several recent cases, the Tax Court concluded that *Colony* required the same interpretation of the current Code. See, e.g., *Intermountain Ins. Serv. of Vail, LLC v. Comm'r*, 98 T.C.M. (CCH) 144 (2009); *Bakersfield Energy Partners, LP v. Comm'r*,

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128 T.C. 207 (2007), *aff'd*, 568 F.3d 767 (9th Cir. 2009). (As discussed below, *Intermountain* was subsequently reversed.)

- (iii). Some district courts disagreed with the Tax Court and held for the government. *See, e.g., Burks v. United States*, 2008 U.S. Dist. LEXIS 109876 (N.D. Tex June 13, 2008); *Home Concrete & Supply, LLC v. United States*, 599 F. Supp. 2d 678 (E.D.N.C. 2008). (As discussed below, both of these decisions were later overturned.) Initially, however, the Ninth and Federal Circuits agreed with the Tax Court and held for the taxpayer. *Bakersfield Energy Partners, LP v. Comm'r*, 568 F.3d 767 (9th Cir. 2009); *Salman Ranch, Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009).
- (iv). The IRS and Treasury Department issued temporary regulations in 2009, 74 Fed. Reg. 49,321 (Sept. 28, 2009), and final regulations in 2010, 75 Fed. Reg. 78,897 (Dec. 17, 2010), to establish that an overstatement of basis was an omission of gross income. Treas. Reg. §§ 301.6501(e)-1, 301.6229(c)(2)-1. Since the regulations were issued:
 - ◆ Two circuits have held for taxpayers, declining to follow the final regulations. *Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. 2011), *rev'g* 599 F. Supp. 2d 678 (E.D.N.C. 2008); *Burks v. United States*, 633 F.3d 347 (5th Cir. 2011), *rev'g* 2008 U.S. Dist. LEXIS 109876 (N.D. Tex June 13, 2008).
 - ◆ Four circuits have held for the government. *Grapevine Imps., Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 2011) (reversing its position in the *Salman Ranch* case); *Beard v. Comm'r*, 633 F.3d 616 (7th Cir. 2011); *Salman Ranch, Ltd. v. Comm'r*, 2011 U.S. App. LEXIS 10910 (10th Cir. 2011); *Intermountain Ins. Serv. of Vail, LLC v. Comm'r*, 2011 U.S. App. LEXIS 12476 (D.C. Cir. 2011).
 - ◆ The Ninth Circuit has not yet revisited the issue, after ruling for the taxpayer, since the regulations were issued.
 - ◆ The Second Circuit is currently considering the issue on appeal of *Wilmington Partners, LP v. Comm'r*, 2010 U.S. Tax Ct. LEXIS 56 (2010).
- (v). Petitions for certiorari have been filed in several of the cases above and the Supreme Court is likely to hear the issue.

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- (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).
 - (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).

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- (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.
 - ◆ 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).

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- (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).

C. 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).

D. 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 other 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.

E. Notice of Final Administrative Adjustment ("FPAA")

- 1. This is the equivalent of the statutory notice of deficiency for partnerships.

F. 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).
 - (i). 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

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day after the FPAA is mailed. *Barbados #6, Ltd. v. Comm’r*, 85 T.C. 900 (1985).

- (c). 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-thru partner, the amount is based on the exposure of the indirect partners who own interests through that pass-thru partner. Treas. Reg. § 301.6226(e)-1(a)(1).)
- (d). 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, 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

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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).

G. 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

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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). This is limited to penalties attributable to partnership items. A penalty attributable to a nonpartnership item such as outside basis cannot be determined by the court. *Petaluma FX Partners LLC v. Comm'r*, 591 F.3d 649 (D.C. Cir. 2010).

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V. TEFRA Refund Claim Process

A. Administrative Adjustment Request (“AAR”)

1. This 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.”)

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- (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 to file an AAR and 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.

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- (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.

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Practice tip: Given the minimal guidance and lack of binding precedent in this area, if the I.R.C. § 6227 period has expired, it may still be possible to file an AAR. The tax practitioner should consider whether it is possible (and worthwhile) to file an AAR and argue that it was filed 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.

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- (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-thru 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.

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- (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 disallowed. A petition for judicial review of an AAR must be filed no later than two years after the AAR is filed. 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.*

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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).

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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 identity 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.*

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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.