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**Federal Income Tax Examinations
of Pass-Through Entities**

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I. INTRODUCTION

A. Statutory Scheme (IRC §§ 6221-6234)

1. Determination of tax treatment at partnership level (§ 6221)
2. Requirement that partner's return be consistent with partnership return (§ 6222)
3. Notice requirements (§ 6223)
4. Rights of partners to participate in administrative proceedings (§ 6224)
5. Restriction on assessment and collection (§ 6225)
6. Judicial review (§§ 6226, 6228)
7. Administrative adjustment requests (§ 6227)
8. Statute of limitations (§ 6229)
9. Additional administrative issues—coordination with deficiency proceedings, mathematical and computational errors, limitations on credits or refunds, required disclosures by TMP (§ 6230)
10. Definitions and special rules (§ 6231)

B. Key Definitional Provisions – Recent Developments

1. Tax Matters Partner

- a. IRC § 6231(a)(7)

TAX MATTERS PARTNER.— The tax matters partner of any partnership is—

- (A) the general partner designated as the tax matters partner as provided in regulations, or

(B) if there is no general partner who has been so designated, the general partner having the largest profits interest in the partnership at the close of the taxable year involved [...].

If there is no general partner designated under subparagraph (A) and the Secretary determines that it is impracticable to apply subparagraph (B), the partner selected by the Secretary shall be treated as the tax matters partner [...].

The authority and responsibilities of a TMP are set forth in Treas. Reg. §§ 301.6223(g)-1 and 301.6230(e)-1.

b. Former partner may serve as TMP

(1) *Monetary II Ltd. P'ship v. Commissioner*, 47 F.3d 342 (9th Cir. 1995) (holding that extension of statute of limitations on assessment by former partner and TMP who had resigned from partnership was validly executed; former partner not barred from serving as TMP once he resigns from partnership, and regulations do not require TMP to be a partner at the time of his designation as such).

c. Conflict of interest may disqualify TMP

(1) *River City Ranches #1 Ltd. v. Commissioner*, 401 F.3d 1136 (9th Cir. 2005) (remanding for additional discovery where TMP's ongoing fraud and theft against partners could create conflict of interest, as TMP could have interest in extending statute of limitations in order to delay discovery of fraud or garner favor from the government).

(2) *Transpac Drilling Venture 1982-12 v. Commissioner*, 147 F.3d 221 (2d Cir. 1998) (reversing Tax Court ruling that allowed TMP subject to IRS criminal investigation to extend § 6229 statute of limitations after the limited partners refused to grant the extensions, after finding that IRS pressure on TMP created conflict of interest that disqualified TMP from binding the partnership).

(3) *Leatherstocking 1983 P'ship v. Commissioner*, T.C. Memo 2006-164 (2006) (holding that criminal investigation of TMP did not create disabling conflict of interest that would invalidate consents to extend statute of limitations signed by TMP, because TMP was not under pressure to ignore fiduciary duties to limited partners).

2. Partnership Items

a. IRC § 6231(a)(3)

PARTNERSHIP ITEM.—The term “partnership item” means, 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.

b. Characterization of partnership’s transactions is a partnership item.

(1) *River City Ranches #1 Ltd. v. Commissioner*, 401 F.3d 1136 (9th Cir. 2005) (holding that issue of whether partnership’s transactions were designed merely to secure tax benefits is a “partnership item” within the meaning of § 6231(a)(3) because the nature of the transaction determines whether the partners pay a higher rate of interest on back taxes due and thus determines the partners’ personal income taxes).

c. Partnership’s allocation of partner’s distributive share between the partner and the partner’s bankruptcy estate is a partnership item.

(1) *Katz v. Commissioner*, 335 F.3d 1121, 1129 (10th Cir. 2003) (“To say that the *allocation* is not a partnership item is to confuse the process with the result. [...] The partnership item is, of course, the result of the allocation of the partnership’s income, losses, etc; but the allocation process itself is not a partnership item. The requirement of a partnership-level proceeding is triggered regardless of how the partnership item was calculated. There may be sound policy reasons for not requiring a full-blown partnership-level proceeding when an alleged error in one partner’s return affects only one other taxpayer rather than all the partners. But for now the law is otherwise.”).

d. Non-partner’s tax treatment of its payment to partnership is not a partnership item.

(1) Rev. Rul. 2006-11, 2006-12 I.R.B. 635 (tax treatment on consolidated return of parent corporation’s payment to a partnership in which parent is not a partner is not a partnership item within the meaning of § 6231(a)(3), even if another member of the affiliated group is a partner in the partnership).

3. Affected Items

a. IRC § 6231(a)(5)

AFFECTED ITEM.—The term “affected item” means any item to the extent such item is affected by a partnership item.

b. Non-partner’s tax treatment of its payment to partnership is not an affected item.

- (1) Rev. Rul. 2006-11, 2006-12 I.R.B. 635 (tax treatment on consolidated return of parent corporation’s payment to a partnership in which parent is not a partner is not a partnership item within the meaning of § 6231(a)(3), even if another member of the affiliated group is a partner in the partnership).

II. STATUTE OF LIMITATIONS

A. Interaction of §§ 6229 and 6501

1. IRC § 6229(a)

GENERAL RULE.— 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 latter of—

- (1) the date on which the partnership return for such taxable years was filed, or
(2) the last day for filing such return for such year (determined without regard to extensions).

2. IRC § 6501(a)

GENERAL RULE.— Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) [...].

B. Recent Decisions

1. *Rhone-Poulenc Surfactants and Specialties, L.P. v. Commissioner*, 114 T.C. 533 (2000) (en banc), appeal dismissed, 249 F.3d 175 (3rd Cir. 2001) (holding that §§ 6229 and 6501 contain alternative periods in which tax related to partnership items may be assessed, and the provision that expires later governs: the three year period contained in IRC § 6229(a) is a minimum limitations period that “may expire before or after the § 6501 maximum period.”)
 - a. I.R.S. Litig. Guideline Mem. 199905040. The IRS takes the position that § 6501 is the controlling statute for assessments, and that § 6229 merely extends the § 6501 general limitations period.
2. *Andantech LLC v. Commissioner*, 331 F.3d 972 (D.C.Cir. 2003) (holding that 6229(a) is “not a separate limitations period, but simply set[s] a minimum or allow[s] an extension of an assessment period, complementing the one set in § 6501”).
3. *AD Global Fund, LLC v. United States*, 68 Fed.Cl. 663 (2005), *interlocutory appeal docketed*, No. 810, 167 Fed. Appx. 171 (Fed. Cir. Jan. 9, 2006) (holding that § 6229(a) contains an extension of time rather than a separate statute of limitations on partnership items; issuance of FPAA suspends running of three-year statute of limitations on income tax assessments under IRC § 6501(a)).
4. *Grapevine Imp., Ltd. v. United States*, 71 Fed. Cl. 324 (2006) (holding that “section 6229(a) is a minimum period, not an independent limitations period exclusive of section 6501;” issuance of FPAA suspends statute of limitations on income tax assessments in IRC § 6501(a) as it applies to individual partners). *See also Schumacher Trading Partners v. United States*, 2006 U.S. Claims LEXIS 224 (2006).
5. *Ginsburg et al. v. Commissioner*, 127 T.C. No. 5 (2006) (holding that, where partnership assessment period had expired but individual periods remained open, notice of deficiency issued to individual partners in connection with both partnership and affected items was untimely because the Forms 872 did not specifically reference adjustments for partnership items).
6. I.R.S. Chief Counsel Advice 200414045 (IRS may initiate TEFRA proceeding for year for which assessment period has expired for all partners, where partners may have claimed losses attributable to partnership items for that year in later open years).

C. Extending the Statute of Limitations

1. Form 872-P: For use by TMP to extend statute at partnership level.

2. Form 872: Used to extend § 6501 statute, but can also be used by individual partner to extend statute on partnership items and affected items if expressly designated (specific language required).
3. Form 872-I: Used to extend statute by individual partners related to partnership items and affected items. No additional designation required.

III. ADMINISTRATIVE PROCESS

A. Every Partnership Return Screened

1. Three screening methods. *See* IRM 4.1.5.11.
 - a. DIF (“Discriminate Function System”) selected returns;
 - b. Non-DIF selected returns; and
 - c. “Automatics”—Partnership returns selected for screening by “classifiers”
 - (1) Partnerships with more than \$10 million in assets. IRM 4.1.3.1.3.
 - (2) Partnerships with gross receipts or gross income of \$500,000 or more. Michael I. Saltzman, IRS Practice and Procedure, ¶¶ 8.03[3][f].
2. Tax shelters (IRM 4.1.4.34)
 - a. Definition for purposes of IRM 4.1.4.34
 - (1) “Tax shelters utilize improper or extreme interpretations of law or the facts to secure for investors substantial tax benefits which are clearly disproportionate to the economic reality of the transaction.”
 - (2) To determine whether a transaction is a “tax shelter” under this definition, the following factors are considered: large net losses; low gross income; large amounts of investment credit; first year returns; final returns; IRC § 761(a) elections; non-operating entities; passive investors; nonrecourse or not-at-risk questions not answered or answered affirmatively (other than real estate); active engagement in identified tax shelter area; and negative capital account if partnership return does not involve real estate.

- b. “For TEFRA shelters, Service/Customer Service Center Classification will screen investor returns to determine if the deductions and/or credits from the pre-filing notification were claimed.”
 - c. Further screening depends on whether deductions and/or credits from the pre-filing shelter are claimed, and whether there are other shelters on the investor return.
3. Factors in selection for audit (IRM 4.1.5.11.1)
- a. Entire return as well as each line item screened for highest examination potential.
 - b. General instructions for individual and corporate returns apply equally to partnership returns. See IRM 4.1.5.9.1, IRM 4.1.5.9.19, IRM 4.1.5.10.1.
 - c. Partnership-specific areas of focus: additional contributions that should be characterized as sale or exchange; disproportionate allocation of losses or specific deductions to partners; withdrawal of partners may include “phantom gain” through assumption of liabilities by others; characterization of sale or exchange of partnership assets; component or other depreciation method resulting in shorter lives.
 - d. Features of initial and first year partnership returns “are productive.”
 - (1) Capital contributions and reflection of gain/loss on partner return; services in lieu of capital contribution; large losses, either on partnerships commencing business late in year, or in relation to investments; large depreciation deduction, especially where property not placed in service in that year; capitalization issues.

B. Consequences of Dissolution of Partnership

- 1. TEFRA procedures continue to apply after a partnership is liquidated.
 - a. *Chef’s Choice Produce, Ltd. v. Commissioner*, 95 T.C. 388, 396 (1990) (“We conclude that the continued existence of the partnership entity itself is not essential to the operation of the partnership procedures. . . . The dissolution or termination of a partnership in a year subsequent to the years adjusted by the FPAA has no effect on the outcome of a partnership action filed with respect to the years when the partnership was in existence.”).

C. TEFRA Procedures Not Always Followed

1. Treasury Inspector General for Tax Administration, *Examination of Partnerships Often Do Not Follow All Procedures Required by the Tax Equity and Fiscal Responsibility Act of 1982* (Jul. 31, 2006) See <http://www.ustreas.gov/tigta/auditreports/2006reports/200630106fr.html>
 - a. Of 60 partnership return examinations closed between Oct. 1, 2003 and June 30, 2005 and examined by the inspector general's office, one or more required procedures were not followed in more than half.
 - b. In two cases, TEFRA procedures were not followed in initiation and conduct of exam. Because there was no record of proper notice, if assessments had been made, they would have been invalid.
 - c. In 33 cases, no documentation of determination regarding TEFRA status for exam.
 - d. In 23 of 60 cases, no documentation of checks to determine whether TMP was qualified to represent the partnership.

IV. ADMINISTRATIVE SETTLEMENT

A. Forms and Procedures (IRM 4.31.2.2.11)¹

1. Form 870-PT, Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts: Typically used for administrative partnership settlements. First issued with the 60-day letter as statement of proposed adjustments to partnership items (not used for affected items). If a protest is filed, and the Appeals Officer adopts a new position, that position is communicated on this form.
2. Form 870-LT, Agreement for Partnership Items and Partnership Level Determinations as to Penalties, Additions to Tax, and Additional Amounts and Agreement for Affected Items: This form permits a partner to agree to both partnership adjustments (including penalties) and affected items or only to the partnership adjustments. Part I of this form is identical to Form 870-PT. Part II allows the partner to agree to partner-level determinations for affected items and the related penalties and additions to tax as well as to the assessment of the tax, penalties, and interest due without following the normal deficiency proceedings (*i.e.*, 30-day letter or statutory notice).

¹ Forms 870-P and 870-L are used for tax years ending before August 6, 1997. IRM 4.31.2.2.11.

3. Form 906, Closing Agreement: The closing agreement can be limited to the TEFRA partnership adjustments and affected items at issue and need not resolve any other issues in that partner's taxable year. The IRS will typically want to use Form 870-PT or Form 870-LT in conjunction with Form 906, unless the closing agreement incorporates a waiver of the restriction on assessment of partnership items. The Internal Revenue Manual indicates that "[c]losing agreements in TEFRA partnerships should be used only in unusual circumstances." IRM 8.13.1.2.6:(3).

B. Limitations on Role of Tax Matters Partner

1. When negotiating a settlement, the tax matters partner cannot bind any notice partner (or any member of a five percent notice group). IRC §6224(c)(3)(A).
2. The tax matters partner also cannot bind any partner on a settlement of affected item issues. See IRC §6224(c)(1) (defining a settlement agreement to which the TMP may bind other partners as extending only to partnership items).
3. Non-notice partners can file a written "no settlement" statement negating the TMP's settlement authority. IRC §6224(c)(3)(B); Treas. Reg. § 301.6224(c)-1(c).

C. Consistency Requirement

1. If the IRS settles partnership items of one partner, that same settlement must be offered to any partner whose items are still partnership items who requests the same settlement. IRC § 6224(c)(2).

V. LITIGATION: THE PETITION FOR READJUSTMENT

A. Principal Place of Business Requirement for District Court

1. IRC § 6226(a)(2)

PETITION BY TAX MATTERS PARTNER.—Within 90 days after the day on which a notice of a final partnership administrative adjustment is mailed to the tax matters partner, the tax matters partner may file a petition for readjustment of the partnership items for such taxable year with— [...]

- (2) the district court of the United States for the district in which the partnership's principal place of business is located [...].

2. Treas. Reg. § 301.6226(a)-1(a)

In general.—The principal place of a partnership's business for purposes of determining the appropriate district court in which a petition for a

readjustment of partnership items may be filed is its principal place of business as of the date the petition is filed.

3. Little guidance on definition of “principal place of business” for a partnership.
 - a. FSA 1999-1059, 1999 TNT 95-44 (undated) (concluding that a partnership’s principal place of business is where it makes its major business decisions, not where its assets are located).
 - b. “Another argument worthy of consideration relates to the taxpayer’s admission in its petition filed with the Tax Court regarding the partnership’s principal place of business. In *Am. Title Ins. Co. v. Lacelaw Corp.*, 861 F.2d 224 (9th Cir. 1988), the court held that a judicial admission would be conclusively binding on the petitioner, absent an amendment of the pleading.” *Id.*
4. Principal place of business requirement is a venue provision – it is not jurisdictional.
 - a. *Transcapital Leasing Assocs., 1990-II, L.P., et al. v. United States*, 398 F.3d 1317 (Fed. Cir. 2005) (holding that “the ‘principal place of business’ language in 26 U.S.C. § 6226(a)(2) is a venue provision.”)

B. Jurisdictional Deposit Requirement (IRC § 6226(e))

1. Venue differences
 - a. A deposit is required for filing a readjustment petition in District Court or the Court of Federal Claims.
 - b. Filing a readjustment petition in the Tax Court does not require a deposit.
2. Determining amount of deposit
 - a. Calculation of deposit is based on the effect of the claimed partnership adjustments on the return of the partner filing the petition. The calculation does not take into account the effect of the claimed adjustments on the returns of the other partners.
 - b. Deposit must equal the difference between:
 - (1) The tax liability reflected on the partner’s return as filed;
 - (2) The tax liability that would be reflected on the partner’s return if the treatment of the partnership items on the

partner's return were made consistent with the partnership items on the partnership return as adjusted by the FPAA. *See* Treas. Reg. § 301.6226(e)-1T(a).

3. Procedure for making deposit
 - a. The deposit can be made at the walk-in counter of any local IRS office.
4. Effect of deposit on taxes and interest
 - a. Deposit is generally not treated as a payment of tax but rather as an estimate of the filing partner's own liability, assuming the adjustments asserted in the FPAA are ultimately held to be correct. *See* IRC § 6226(e)(3); Treas. Reg. § 301.6226(e)-1T(c).
 - b. The amount deposited is treated as a payment of tax for purposes of computing interest. IRC § 6226(e)(3); Treas. Reg. § 301.6226(e)-1(b).

C. Restrictions on Assessment

1. If a timely readjustment petition is filed in Tax Court
 - a. No assessment attributable to a partnership item may be made before the decision of the Tax Court has become final. IRC § 6225(a)(2).
2. If a timely readjustment petition is filed in District Court or the Court of Federal Claims
 - a. No assessment attributable to a partnership item may be made before the close of the 150th day after which the FPAA was mailed to the tax matters partner. IRC § 6225(a)(1).
 - (1) With respect to the partner that made the jurisdictional deposit, the IRS may apply the amount deposited against any deficiency resulting from the partnership items adjusted by the FPAA. Treas. Reg. § 301.6226(e)-1(d).

D. Raising Penalty Defenses in Partnership Proceeding

1. For TEFRA partnerships, penalties are determined at the partnership level, and partner-level defenses can only be raised in a separate refund action following assessment and payment of the penalty. *See* IRC §§ 6221; 6230(a)(2)(A)(i); 6320(c)(1)(C); Treas. Reg. §§ 301.6221-1(c) and (d).

VI. S CORPORATIONS

A. TEFRA Generally Inapplicable

1. TEFRA procedures not applicable to S corporations for tax years beginning after December 31, 1996. Small Business Job Protection Act of 1996, P.L. 104-188, § 1307(c)(1).

B. Selection for Audit (IRM 4.1.3.1.4)

1. S corporation returns having assets under \$10,000,000 are computer scored under the DIF System. All other S corporation returns are automatically selected for exam.
 - a. Special screening of S corporation returns is triggered by the following: partnership issues; a disclosure statement; international issues; a corporation return (Form 1120) that Returns Processing converted to an S corporation return (Form 1120S); Form 8283, Non-Cash Charitable Contribution; Form 8586, Low Income Housing Credit; and the first year of Subchapter S filing.

C. Statute of Limitations

1. IRC § 6501 controls.
2. Following *Bufferd v. Commissioner*, 506 U.S. 523 (1993), the three year assessment period under § 6501 runs from the date of the shareholder's filing of its individual return. This was codified by IRC § 6501(a) in 1997.

VII. RESOURCES

- A. BNA Tax Management Portfolio, *Audit Procedures for Pass-Through Entities*, No. 624.
- B. Michael I. Saltzman, *IRS Practice and Procedure*, ¶¶ 8.17-8.22.
- C. Manual Handbook 8113: *TEFRA Appeals Handbook*.
- D. IRM 4.31: *Flow-Through Entity Handbook*.
- E. IRM 4.1.5: *Classification*.
- F. IRS Partnership Audit Technique Guide, available at <http://www.irs.gov/businesses/partnerships/article/0,,id=134688,00.html>

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