Auditing Large Partnerships and TEFRA: Where We Are and Where We Are Going

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PRESENTATION DRAFT

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I. Introduction

Subchapter K was re-codified in 1954 with an understanding that partnerships were used primarily by small business.[1] However, during the 1970's and early 1980's large partnerships were formed and syndicated as tax shelters (mostly for individuals).[2] Following an explosion of mostly individual tax shelters in the 1970's and early 1980's, Congress enacted a unified partnership audit procedure for all but certain small partnerships as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").[3] Congress also enacted other legislation to attack the tax shelters of the day.[4] Few, if any, of the tax shelters syndicated during the 1970's and 1980's exist (due mostly to the enactment of section 469).

[1] *See* H.R. Rep. No. 83-1337, 2d Sess. 65 ("It should be noted that the partnership form of organization is much more commonly employed by small businesses and in farming operations than the corporate form.").
[2] DEP'T OF THE TREASURY, THE PRESIDENT'S 1978 TAX PROGRAM 118 (1978) [hereinafter 1978 TAX PROGRAM].
[3] The Tax Equity and Fiscal Responsibility Act of 1982, §§ 401-407, Pub. L. No. 97-248, 96 Stat. 324 (1982) [hereinafter TEFRA or TEFRA partnership audit rules or TEFRA partnership audit procedures]. The unified partnership audit procedure enacted in 1982 are generally referred to by the acronym "TEFRA."
[4] *See* sections 465 and 469.

However, during the more than 30 years since the TEFRA partnership audit rules were enacted, there has been a dramatic shift in the way U.S. taxpayers organize their business operations and pay their taxes. Partnerships – not C corporations -- are being used more and more by operating businesses of increasing complexity. The increased use of partnerships (and the decrease in the use of C corporations) as the vehicle of choice by operating businesses has been driven, in large part, by the repeal of *General Utilities*,[5] States' creation of limited liability companies,[6] and the promulgation of the check-the-box regulations.[7] Between 2002 and 2011, the number of partnerships increased 47 percent to 3.3 million while the number of C corporations decreased 22 percent to 1.6 million.[8] The number of large partnerships (those with 100 or more direct and indirect partners) has grown even faster – from 2002 to 2011 the number of large partnerships more than tripled to more than 10,000 (and these large partnerships hold trillions of dollars of assets).[9]

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[5] The *General Utilities* doctrine arose in *General Utilities & Operating Co. v. Helvering,* 296 U.S. 200 (1935), and is codified in section 311(a)(2). Congress began repealing the *General Utilities* doctrine with the enactment of section 311(d)(1) in 1969 and eventually laid it to rest with the enactment of section 311(b) in 1986. *See Pope & Talbot, Inc. v. Commissioner,* 162 F.3d 1236, 1239-40, (9th Cir. 1999) (discussing some of the history of the repeal of the *General Utilities* doctrine).

[6] Scott R. Anderson, The Illinois Limited Liability Company: A Flexible Alternative for Business, 25 Loy. U. Chi. L.J. 55, 59-60 (noting that, although the origin of the limited liability company in the United States dates back to a business entity called the "partnership association" in the late 1800s, Wyoming became the first state in the nation to adopt limited liability company legislation in 1977).

[7] Treasury Decision 8697 (Dec. 17, 1996).

[8] UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, REPORT TO CONGRESSIONAL REQUESTERS, LARGE PARTNERSHIPS: WITH GROWING NUMBER OF PARTNERSHIPS, IRS NEEDS TO IMPROVE AUDIT EFFICIENCY 1, September 2014 [hereinafter GAO FINAL REPORT].

[9] *Id.*

Moreover, the number of partnerships with more than one million partners increased from 17 in tax year 2011 to 1,809 in tax year 2012.[10]

Since enactment, the TEFRA partnership audit rules have changed a number of times (as discussed below). One leading commentator has referred to the TEFRA partnership audit rules as "being in a state of flux" even after thirty years.[11] Seeing little, if any, remaining benefit of the TEFRA partnership audit rules, at least one commentator has called for the repeal of nearly all of the TEFRA partnership audit rules.[12] Recently, both Obama Administration and U.S. House of Representatives Committee on Ways and Means Chairman, David Camp, have proposed substantial changes to or outright repeal and

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[10] *Id.* at 14. The GAO Final Report did not indicate a reason for the explosion of partnerships with more than one million partners from 2011 to 2012. A big reason is likely a recent loosening by the Service of the definition of "qualifying income" under section 7704(d). *See* Amy S. Elliott, PTPs Expand as Fracking, Real Property Rents Generate Qualifying Income, Tax Notes Today, September 12, 2012 ("The use of publicly traded partnerships (PTPs, sometimes called master limited partnerships or MLPs) is coming back into vogue some five years after investment funds started taking advantage of the structure. The renaissance appears to stem from a recent flurry of favorable IRS private letter rulings that expand taxpayers' notions of what constitutes qualifying income under section 7704, particularly in the areas of natural gas hydraulic fracturing and real property rents."). The Service has recently placed a moratorium on issuing any new private letter rulings regarding what constitutes qualifying income under section 7704. *See* Amy S. Elliott, IRS Has Stopped Ruling on Publicly Traded Partnership Qualifying Income, Tax Notes Today, March 31, 2014, 2014 TNT 61-4 (reporting a Service announcement to stop issuing private letter rulings on what constitutes "qualifying income" for purposes of section 7704 and noting that "[t]he pause comes following a recent flurry of favorable letter rulings that expanded some taxpayers' notions of what constitutes qualifying income under section 7704, particularly in the areas of natural gas hydraulic fracturing (fracking) and real property rents.").

[11] Ama Sarfo, Tax Court Settles Outside Basis Rules for Partnerships, Law360, June 3, 2014 (interview statement of Professor Robert Morrow, Chapman University Fowler School of Law).

[12] PETER A. PRESCOTT, JUMPING THE SHARK: THE CASE FOR REPEALING THE TEFRA PARTNERSHIP AUDIT RULES, 11 Fl. Tax Rev. 503, 505 (2011) [hereinafter PRESCOTT].

replacement of the TEFRA partnership audit rules.[13] The TEFRA partnership audit rules have also come under scrutiny within the past year because few large partnerships are selected for audit and, when selected, the audits typically result in no change to the partnership return.[14]

After more than 30 years of change, there are currently three different audit regimes that may apply to a partnership depending on the number of partners in the partnership and whether the partnership has elected the TEFRA partnership audit rules to apply.[15] For partnerships with 10 or fewer partners, the Service generally applies the audit procedures for individual taxpayers, auditing the partnership and each partner separately. For most large partnerships with more than ten partners, the Service conducts a single administrative proceeding (a TEFRA audit) to resolve audit issues regarding partnership items that are more appropriately determined at the partnership level than at the partner

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[13] U.S. DEPARTMENT OF THE TREASURY, OFFICE OF TAX POLICY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS 217-219 (proposing to mandate the electing large partnership audit and adjustment procedures for any partnership with at least 1,000 partners) [hereinafter 2014 GREEN BOOK]; J. COMM. ON TAX'N, TECHNICAL EXPLANATION OF THE TAX REFORM ACT OF 2014, A DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS TO REFORM THE INTERNAL REVENUE CODE: TITLE III – BUSINESS TAX REFORM 249-259, February 26, 2014 (JCX-14-14) [hereinafter 2014 CAMP PROPOSAL].

[14] *See*, *e.g.*, AMY S. ELLIOTT, AUDIT PROOF? HOW HEDGE FUNDS, PE FUNDS, AND PTPS ESCAPE THE IRS, 136 TAX NOTES 351(2012) (quoting, among others, John Curnutt, a former national partnership industry specialist at the IRS who retired in 2000 as saying, "It's almost beyond my comprehension that a manager would allow an agent to open a case that had 1,000 partners" and "[i]f you're going to have 1,000 partners and all that involves, you better have an issue that's a billion-dollar adjustment – something that is going to be large – because of the expenditure of time"); Laura Saunders, Investments That Elude IRS Scrutiny: Master Limited Partnerships and Hedge Funds are Often too Complicated to be Audited, Tax Report, Wall Street Journal, April 25, 2014 (discussing the low audit rate of large partnerships compared to large corporations); GAO FINAL REPORT *supra* note 8; and Koskinen: More Training on Subchapter K Won't Fix Audit Issues, Tax Notes Today, Oct. 14, 2014, 2014 TNT 203-2.

[15] 2014 CAMP PROPOSAL at 249.

level. A third audit regime applies to partnerships with 100 or more partners that elect to be treated as electing large partnerships for flow-through reporting and audit purposes.

This Article examines the TEFRA and large partnership audit rules and argues that they do serve an important purpose, but that they should be dramatically overhauled to eliminate numerous inefficiencies and to enable them to better serve the policy goals for which they were enacted. The goal of such changes should be to drastically increase both the absolute numbers of partnership audits and the number of changes made to those partnership returns (including, importantly, changes made to partnership allocations between or among partners) that are audited. The goal should be to bring the numbers of returns audited and changes made at least in line with the audit and change rates for comparable C corporation audits. Part II of this Article examines life before TEFRA and Part III provides a brief legislative history of TEFRA. Thereafter, Part IV examines the judicial highlights of TEFRA before Part V critiques TEFRA by examining what TEFRA does and does not do well. Part VI discusses the reaction to TEFRA during the years since its enactment. Finally, Part VII makes the case that TEFRA can be saved. In particular, Part VII recommends that the TEFRA partnership audit rules should be dramatically overhauled to eliminate numerous inefficiencies and improve effectiveness consistent with the stated policy goals of TEFRA. If the TEFRA partnership audit rules cannot be dramatically overhauled such that the partnership audit rules better achieve the stated policy objectives underlying TEFRA, then newly formed partnerships with greater than 100 partners should be taxed as corporations. Part VII also suggest that regardless of whether the TEFRA partnership audit rules are dramatically overhauled or partnerships with greater than 100 partners are taxed as corporations, a number of changes should be made to improve the efficiency and effectiveness of Service audits of partnerships of any size.

II. Life Before TEFRA: Why TEFRA?

A necessary starting point to evaluate the TEFRA partnership audit rules is an examination of the partnership audit rules in place prior to TEFRA, the events triggering the enactment of the TEFRA partnership audit rules, and TEFRA's policy justifications. Prior to embarking to explore life before TEFRA, the next section briefly discusses U.S. partnership taxation in general.

A. U.S. Partnership Taxation in General

For income tax purposes, partnerships are not taxable entities. Instead, a partnership is a conduit, in which the items of partnership income, deduction, and credit are allocated among the partners for inclusion in their respective income tax returns. Partnerships are required to file an annual information tax return (Form 1065) setting forth the partnership's income, deductions, and credits, the names and addresses of each partner during the year and, importantly, each partner's distributive share[16] of these items (along with certain other information required by the regulations).[17] (The partnership reports each partner's respective distributive share of partnership items on a separate Schedule K-1 (Form 1065) sent to each partner.) Partnerships must also make several tax

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[16] The term "distributive share" is not synonymous with the term "distribution." Distributive share refers to each partner's share of total partnership income (an allocation of income), whereas a distribution is a payment of cash by the partnership to one of its partner. A partner is taxed on the partner's distributive share. A partner is generally not taxed on receipt of a distribution (i.e., a payment of cash) unless the amount distributed exceeds the partner's outside basis in the partner's interest in the partnership. *See* sections 705 and 731.

[17] *See* Section 6031; Treas. Reg. § 1.6031(a)-1(a); and IRS Form 1065 (including Schedule K-1 to IRS Form 1065) and the instructions thereto.

elections on its U.S. federal tax return.[18] Because partnerships do not pay tax, however, other than reporting the accurate amount of total partnership taxable income or loss and making certain tax elections, the main purpose of the U.S. partnership income tax return is to allocate total partnership taxable income between or among the partners of the partnership. The accurateness of these allocations will dictate what amount of the partnership's total taxable income or loss must be included in each partner's own income tax return.

B. Partnership Audits, Events, and Problems Preceding TEFRA

As stated immediately above, partnerships do not pay tax. Because a partnership is a conduit rather than a taxable entity, adjustments in tax liability may not be made at the partnership level. Rather, adjustments must be made to each direct or indirect tax-paying partner's income tax return at the time the return is audited.

Prior to TEFRA, a settlement agreed to by one partner with the Service was not binding on any other partner or on the Service in dealing with other partners. Similarly, judicial determinations of an issue relating to a partnership item generally were conclusive only to those partners who were parties to the proceeding. Thus, each separate deficiency or overpayment attributable to the partnership may have been the subject of a separate administrative proceeding, and, at the option of each partner, the subject of a separate judicial proceeding.[19] Moreover, each partner was free to go in a different direction with respect to the partnership audit. So, for example, if issues remain unresolved at the end of

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[18] *See*, *e.g.*, section 703(b) and Treas. Reg. § 1.6031(a)-1(b)(5)(ii) (a partnership not otherwise required to file a U.S. partnership return but wishes to make an election under section 703 must file a return citing this regulation and stating the election being made).
[19] 1978 TAX PROGRAM at 121. For a more detailed description of partnership audits before TEFRA *see*, *e.g.*, AM. LAW INST., FEDERAL INCOME TAX PROJECT, pp. 10-14 (Council Draft No. 7, November 24, 1980) [hereinafter ALI COUNCIL DRAFT REPORT NO. 7].

the audit, some partners may seek an appellate review, other partners may wish to go directly to Tax Court, and some partners may wish to pay the assessed tax and seek a refund.[20] Finally, there was no civil penalty for failure to file a partnership return so taxpayers oftentimes simply failed to file any return or file the return late creating problems with each partner's statute of limitations, which began tolling when each partner filed a U.S. federal income tax return.

The TEFRA partnership audit rules were borne out of the tax shelter era of the late 1970s and 1980s[21] – in particular the syndication of limited partnership tax shelters.[22] In arguing for enactment of TEFRA, the Treasury cited an example of "[o]ne promoter [who]

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[20] ALI COUNCIL DRAFT REPORT NO. 7 at 16; 1978 TAX PROGRAM at 122, 125.

[21] For a great discussion of the scope of the overall tax shelter problem of the late 1970s and 1980s, as well as a definition of a tax shelter, *see* D. FRENCH SLAUGHTER, III, THE EMPIRE STRIKES BACK: INJUNCTIONS OF ABUSIVE TAX SHELTERS AFTER TEFRA, 3 VA. TAX REV. 1, 1-10 (1983).

[22] *See*, *e.g.*, 1978 TAX PROGRAM at 71-80 (detailing examples of tax shelter abuse) and 123-24 (explaining that "[t]he problem of effectively auditing partners of partnerships have been present for a long time. However, these problems have been vastly compounded by the widespread use of partnerships in the tax shelter area. The large number of partners involved in syndicated, and often interrelated, tax shelter partnerships makes the Service efforts to ensure compliance with the tax laws extremely difficult under existing administrative and judicial procedures" and that "[t]he size of partnerships, measured by number of partners, has grown dramatically in recent years" and that "[t]his expansion in size of partnerships is attributable to a rapid increase in the number of very large partnerships"); A.B.A. SEC. OF TAX'N, *Proposal as to Audit of Partnerships*, 32 TAX LAW. 551, 551 (1979) (recognizing that "[i]n recent years there has been a proliferation of investment type limited partnerships, and in the wake of this activity there has flowed a series of unique problems with which the Service and taxpayers had to grapple" and that "traditional rules and procedures do not readily lend themselves to the audit of the books and records of investment partners who have varied interests, are scattered across the country, and whose very likely common bond with each other is only the investment in a particular enterprise") [hereinafter 1979 ABA PROPOSAL]; ALI COUNCIL DRAFT REPORT NO. 7, at 14 ("with the enormous growth of syndications over the last decade and increased audit coverage of those partnerships in the last few years, the problems have become overwhelming, according to the Service and practitioners"); and STAFF OF THE JT. COMM. ON TAX'N, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, p. 268 (1982) (JCS 38-82) [hereinafter 1982 BLUEBOOK].

put together over 35 partnerships involving 55,000 partners, for an average of over 1,500 partners per partnership" and noted that "[o]ne of these partnerships has more than 7,500 partners."[23]

Importantly, the Service had already encountering problems auditing partnerships prior to the onslaught of syndicated partnerships.[24] The enormous growth of partnership syndications decade preceding adoption of the TEFRA partnership audit rules, however, magnified the numerous problems the Service had already encountered trying to audit partnerships[25] and caused those problems to become overwhelming.[26]

The exponential increase in the sheer size of partnerships (measured by numbers of partners) greatly increased the Service's burden in conducting partnership audits.[27] Moreover, partnership syndications meant that the partners were often located in different audit districts.[28] The growth in syndicated partnerships was such a problem at the time that he Treasury proposed to classify as corporations all newly-formed limited partnerships that had more than 15 limited partners[29] noting that a syndicated partnership is, to all intents and purposes, the equivalent of a corporation[30] and that the aggregate treatment afforded certain aspects of partnership taxation were intended to offer flexibility

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[23] 1978 TAX PROGRAM at 122, 125. The Treasury then included several organizational structures as examples of multi-tiered structures it had encountered. *Id.* at 126-28.
[24] 1978 TAX PROGRAM at 123 ("The problem of effectively auditing partners of partnerships have been present for a long time. However, these problems have been vastly compounded by the widespread use of partnerships in the tax shelter area."); COUNCIL DRAFT REPORT NO. 7 at 14 ("The present system always had potential problems resulting from its fragmented nature . . . .").
[25] ALI COUNCIL DRAFT REPORT NO. 7 at 14.
[26] *Id.* at 14-15.
[27] 1978 TAX PROGRAM at 123 (")
[28] ALI COUNCIL DRAFT REPORT NO. 7 at 15.
[29] 1978 TAX PROGRAM at 69.
[30] *Id.* at 118 (noting further that "[t]he limited partners are not responsible for the debts of the partnership and have no voice in its day-to-day management").

to members of small partnerships.[31] (At the time, 15 was also the maximum number of shareholders in a Subchapter S corporation.[32]) The Treasury found the comparison to the limit on the number of Subchapter S corporation shareholders significant because, under its proposal, regardless of whether an entity is formed under local law as a corporation or a limited partnership, it will be allowed conduit tax treatment if it is owned by 15 or fewer passive investors.[33])

In addition to sheer size, partnership syndications resulted in the widespread use of multi-tiered structures.[34] Because many wealthy investors in syndicated partnerships invested through pre-existing entities, partnership syndications greatly complicated the organization structure of partnerships and separated the ultimate tax-paying (indirect) partner from a direct ownership interest in the partnership under exam. Multi-tiered ownership structures no doubt existed prior to partnership syndications in the late 1970s and 1980s, but likely not to the extent as existed after the partnership syndication deals became widespread. In fact, the Service reported enormous difficulty in even timely identifying ultimate taxpayers where tiered structures were used.[35]

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[31] *Id.* (noting that "[i]n the case of larger syndicated partnerships with many passive investors, however, [aggregate provisions] complicate the law and are both unnecessary and inappropriate").
[32] *Id.* at 119.
[33] *Id.*
[34] *Id.* at 122, 125.
[35] 1982 BLUEBOOK at 268 ("Where there are tiered partnerships, identifying the taxpayer is difficult."); 1978 TAX PROGRAM at 122, 125 ("”Size alone is not the only troublesome factor. Partnerships may be 'pyramided' in multi-tiered arrangements of enormous complexity. [] Tiering is possible since partnerships may include as partners not only individuals, but other partnerships, as well as corporations, trusts, and other entities."). Multi-tiered structures continue to present problems for the Service trying to audit partnerships. *See, e.g.*, GAO FINAL REPORT at 15-19 (discussing the complex structures of most large partnerships and noting that "[t]iering contributes to complexity" and that tiering arrangements "complicates determining the relationships and allocations of income and

So, what were some of the specific problems the Service faced prior to TEFRA? Commentators and the government had identified several. Most, if not all, of the problems identified can be traced back to the large number of partners and/or tiered and complex partnership structures (identified above).

One problem was obtaining an extension of statutes of limitations by each tax-paying direct or indirect partner prior to its expiration.[36] Prior to TEFRA, the statute of limitations with respect to assessing any tax was the statute of limitations normally applicable to the partner's return and could only be extended by that partner agreeing to the extension by signing Form 872.[37] The Service reported difficulty in even finding the ultimate taxpayers, let alone obtaining extensions of the statute of limitations within the requisite time period.[38]

Another problem the Service had encountered was duplication of effort.[39] The manpower required to handle larger numbers of partners' separate cases for a single item was burdensome and wasteful compared to having a single proceeding.[40] Prior to TEFRA, the Services' ability to obtain unified partnership audit proceedings was dependent on the willingness of the taxpayers (and their representatives) to cooperate.[41] The decision by

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losses within a large partnership structure." *Id.*); U.S. GOVT. ACCOUNTABILITY OFFICE, LARGE PARTNERSHIPS: GROWING POPULATION AND COMPLEXITY HINDER EFFECTIVE IRS AUDITS 1, 7-9, July 22, 2014(Testimony Before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Government Affair, U.S. Senate) [hereinafter GAO SENATE TESTIMONY].

[36] ALI COUNCIL DRAFT REPORT NO. 7 at 15.

[37] *Id.* at 13.

[38] *Id.* at 15; 1978 TAX PROGRAM at 122; 1982 BLUEBOOK at 268.

[39] ALI COUNCIL DRAFT REPORT NO. 7 at 15; 1982 BLUEBOOK at 268.

[40] ALI COUNCIL DRAFT REPORT NO. 7 at 15-16.

[41] *Id.* at 16.

various partners to proceed in different manners led to great duplication of effort and coordination problems on the part of both the Service and the taxpayers' representatives.[42]

A corollary problem to both the statute of limitations and duplication of effort problems was inconsistent results for the same issue applied to different partners.[43] Because each partner was free to proceed in a different manner and in a different jurisdiction, there was not assurance that each partner would achieve the same result.

The fact that an individual partner may be audited on individual items reported on the individual's tax return unrelated to the partnership and may be a partner in other partnerships under audit made the resolution of items relating to any single partnership in a single administrative or judicial proceeding with the other items on the individual's return extremely complex.[44] The inability to obtain a uniform settlement for all partners in a partnership provided a disincentive to the Service to settle with one partner where the issue had to be litigated with respect to other partners and provided a disincentive to any one partner and the Service to settle when later results obtained by others may make them look bad (settlements were hard to obtain).[45]

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[42] *Id.*
[43] *Id.* at 17.
[44] *Id.*
[45] *See*, *e.g.*, *Id.*; 1982 BLUEBOOK at 268; and 1979 ABA PROPOSAL at 552 (stating that "the Committee now accepts the claim that if each partner were left free to litigate the effect of partnership adjustments on his tax return, there would be no incentive to compromise items in dispute" and "[i]t makes sense to expect that an official of the Service will be reluctant to offer a settlement which will later prove to be 'to high' or 'too low' after a court decision on the same facts involving the same partnership" and, finally, "[s]imilarly, the Government would often be unable to obtain concessions from some taxpayers who believe that upon the same facts the position of the Service might be rejected by a court").

Also, prior to 1978, there was no civil penalty imposed on either the partnership or any partner for failure to file, or untimely filing, a partnership return.[46] Further, even if a partnership return were filed, it was not binding on the partners. Each remained free to characterize partnership items on his individual return as she or he saw fit, regardless of whether the characterization was consistent with the partnership return.[47]

Finally, individual taxpayers often proceeded at a very slow pace in order to delay paying the tax and in the hope that the burden on the Service may cause the Service to forget them.[48]

C. TEFRA's Policy Justifications

Against this backdrop, Congress passed TEFRA, and Ronald Reagan signed it into law on September 3, 1982.[49] Congress gave the following reasons for enacting TEFRA:

> Determination of the tax liability of partners resulted in administrative problems under prior law due to the fragmented nature of such determinations. These problems became excessively burdensome as partnership syndications have developed and grown in recent years.
>
> Large partnerships with partners in many audit jurisdictions result in the statute of limitations expiring with respect to some partners while other partners are required to pay additional taxes. Where there are tiered partnerships, identifying the taxpayers is difficult.
>
> Duplication of manpower and administrative and judicial effort was required in some cases to determine the aggregate tax liability attributable to a single partnership item. Inconsistent results could be obtained for different partners with respect to the same item.
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> Unless a statement could be obtained that resolved partnership issues uniformly for all partners in a partnership, settlements were difficult to reach.

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46 STAFF OF THE COMM. ON TAX'N, GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, p. 138 (1979) (JCS-7-79) [hereinafter 1978 GENERAL EXPLANATION].

47 Mortimer M. Caplin & Stuart L. Brown, *Partnership Tax Audits and Litigation After TEFRA*, TAXES--THE TAX MAGAZINE, February 1983, Vol. 61, No. 2, at p. 76 [hereinafter Caplin & Brown].

48 ALI COUNCIL DRAFT REPORT NO. 7 at 16-17.

49 TEFRA. TEFRA was effective for partnership taxable years beginning after September 3, 1982 (the date of enactment). *Id.* at § 407(a)(1).

> The Internal Revenue Service had little incentive to settle with one partner where the issue had to be litigated with respect to other partners.
>
> Prior law was inadequate as applied to foreign partnerships with U.S. partners in that partnership return filing requirements were generally not applicable and partnership records kept outside the United States often could not be reached.[50]

There is widespread agreement that the criteria used to evaluate a tax system are equity (fairness—ability to pay), efficiency (from an economic perspective), and simplicity (ease of administration—the more complicated the rules, the larger the burden on the government to interpret and police the rules).[51] The above-stated reasons fit primarily into the categories of fairness/equity and simplicity/ease of administration. An aspirational indirect goal of TEFRA was to deter future tax-motivated tax shelters (falling into the economic efficiency category)[52] and increasing compliance with the U.S. tax laws.[53]

III. Brief Overview of TEFRA

Because a general understanding of TEFRA and its changes is necessary to the following sections of this Article, this Part will briefly summarize the key provisions of TEFRA partnership audit rules and each significant amendment of those rules, providing a more detailed overview of broader legislation and a summary of the highlights of other

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[50] 1982 BLUEBOOK at 268.

[51] MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 27 (7th ed. 2013).

[52] 1978 TAX PROGRAM at 129 ("Given the fact that under current law, most shelter investors do not take the possibility of extensive IRS audit seriously, it may be expected that the full implementation of this proposal will have a significant impact on shelter activity.").

[53] H.R. Rep. No. 97-760, at 600 (1982) (Conf. Rep.) (noting that "[t]he Senate amendment contains a number of provisions designed to *promote increased compliance* and more efficient administration of the tax laws"). Emphasis added [hereinafter 1982 Conference Report].

narrower legislation. With the exception of certain provisions discussed in Parts IV and V below, a more detailed explanation of the rules is beyond the scope of this Article.[54]

A. TEFRA

As can be seen from the discussion above, the TEFRA provisions relating to partnership audits were essentially an attack on partnership syndications. Moreover, as can also be seen, TEFRA was carefully thought out and comprehensive in nature. Below is a brief summary of the key provisions of TEFRA. The primary impact of TEFRA was to divide the world of partnership audits into two spheres – audits of TEFRA partnerships and audits of non-TEFRA partnerships.[55] For non-TEFRA partnerships, the partnership audit rules did not change. Below is a brief summary of the original TEFRA partnership audit rules.

1. Partnership Level Determination.—TEFRA shifted the audit of partnership items from each individual partner to the partnership level by mandating that the tax treatment of any partnership item, as well as the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) must be made at the partnership level.[56]

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[54] For a more in-depth discussion of the TEFRA rules, *see*, *e.g.*, Merlin G. Briner, *Tax Equity and Fiscal Responsibility Act of 1982*, 1 AKRON TAX J. 29 (1983); Jay Rosen, *TEFRA's New Partnership Auditing Procedures: Was the Left Out?*, 38 TAX L. REV. 479 (1983) [hereinafter ROSEN]; Taylor, Simonson, Winter & Seery, *The Basics of Partnership Litigation*, 7 PRAC. TAX LAW. 67 (1993); John B. Palmer III, *TEFRA Treats Partnerships as Separate Entities Under Its New Procedural Rules*, 58 J. TAX'N 34 (1983); Caplin & Brown, *supra* note 47; BRADLEY P. PEMBERTON & FRANK J. ROSS, JR., THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982: AN ANALYSIS OF MAJOR PROVISIONS, 39 J. MO. BUS. 10 (1983).
[55] *See* section 6231(a)(1) as originally enacted by TEFRA (defining the term "partnership" for purposes of for purposes of Chapter 63, Subchapter C (TEFRA) to mean any partnership required to file a return under section 6031(a), except such term shall not include partnerships having 10 or fewer partners each of whom is a natural person or an estate).
[56] TEFRA at § 402(a). Parts IV and V of this Article will discuss and consider the concept of a "partnership item" in more detail.

2. Tax Matters Partner ("TMP").—TEFRA created a primary representative of the partnership in dealing with the Service as well as the partners.[57] The TMP is generally a general partner designated by the partnership or, if no designation is made, the general partner with the largest profits interest.

3. Consistency Requirement.—Unless the Service is notified of an inconsistent treatment, TEFRA mandated that each partner's tax treatment of partnership items must be consistent with the treatment of those items at the partnership level.[58] The consistency requirement applies not only upon the filing of each partner's return, but also if the partnership return is adjusted as the result of an audit (in which case each partner's return is required to be modified to be consistent with such adjustments).

4. Unified Partnership Audits.—After TEFRA, the audit of certain partnerships were unified proceedings. At the inception, the Service was required to issue formal notice directly to all known partners (other than a less than 1 percent partner in a partnership with more than 100 partners).[59] The TMP was charged with coordinating the proceeding for the partnership, but any partner had the right to participate in the administrative proceedings and to negotiate his or her own settlement with the IRS.[60] Interestingly, while the TMP was charged with keeping each partner informed of all administrative and judicial proceedings at the partnership level of partnership items, the TMP was not subject to penalty for failure to perform.[61] Finally, the administrative proceeding ended when the Service mailed to the TMP (and to each partner who does not

[57] *Id.*
[58] *Id*.
[59] *Id.* Parts IV and V of this Article will discuss and consider the concept of a "partnership item" in more detail.
[60] *Id.*
[61] *Id.*

settle) a notice of final partnership administrative adjustment ("FPAA").[62] Importantly, certain partners can challenge the Service's findings from the audit in court, if the TMP chooses not to do so.[63]

5. Judicial Review.—The FPAA was subject to judicial review in the Tax Court, the Claims Court, or the U.S. District Court.[64] The TMP was allowed to file a petition for readjustment within 90 days of the mailing of the FPAA or, if the TMP did not seek review, then any other partner could file within 60 days after the close of the 90-day period allotted the TMP.[65] TEFRA also provided rules to prioritize multiple petitions, if filed, such that all partners would participate in a single judicial proceeding.[66]

6. Statute of Limitations.—TEFRA provided the Service three years from the later of (a) the partnership's filing date or (b) the filing date of each partner to assess additional tax resulting from an adjustment to partnership items.[67]

7. Requests for Administrative Adjustment ("RAA").—Under TEFRA, any partner could file an RAA of partnership items for a partnership taxable year within three years after the partnership return was filed (or, if later, the last day for filing such return, determined without extension) and before the mailing of a notice of FPAA to the TMP for such taxable year.[68] If the TMP files an RAA, it may serve as an amended return correcting

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[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Id.*
[67] *Id.*; Section 6501(a). Parts IV and V of this Article will discuss and consider the concept of a "partnership item" in more detail.
[68] TEFRA at § 402(a); 1982 Conference Report at 604.

the treatment of items on the original partnership return or, in other cases, it may serve as a claim for a refund.[69]

B. Deficit Reduction Act of 1984

The Deficit Reduction Act of 1984 ("DRA 1984") made certain technical corrections to TEFRA.[70] Additionally, DRA 1984 extended TEFRA to non-partnership entities that file partnership returns.[71]

C. Tax Reform Act of 1986

The Tax Reform Act of 1986 ("TRA 1986") coordinated the Tax Court deficiency procedures with respect to partner level determinations arising from a partnership proceeding with the deficiency procedures applicable to the taxpayer from items unrelated to a partnership proceeding.[72]

D. Technical and Miscellaneous Revenue Act of 1988

Under section 6229, the period for assessing tax "attributable to any partnership item (or affected item)" for a partnership taxable year does not expire before three years after the later of (1) the filing of the partnership return or (2) the last day for the filing of the partnership return (determined without regard to extensions).[73] If a partnership item becomes a non-partnership item, however, the period of limitations does not expire until at least one year after the date on which the partnership items become non-partnership items.[74] The Technical Miscellaneous Revenue Act of 1988 ("1988 Act")[75] provided for one

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[69] *Id.*
[70] §§ 714, Pub. L. No. 98-369, 98 Stat. 494 (1984).
[71] *Id.* at § 714(p). This new provision, as well as other minor technical corrections, were effective as if enacted as part of TEFRA.
[72] TRA § 1875(d)(1) (adding section 6229(g)).
[73] Section 6229(a).
[74] Section 6229(f)(1).

or more extensions with respect to the one-year statute of limitations described in the immediately preceding sentence if agreed to by the Secretary and the taxpayer.[76]

E. Small Business Job Protection Act of 1996

Congress extended the TEFRA partnership audit rules to S Corporations later in 1982 shortly after TEFRA was enacted, but in a separate legislative act.[77] In 1996, however, Congress repealed all rules that caused TEFRA to apply to S Corporations and made conforming amendments throughout the TEFRA provisions.[78]

F. Taxpayer Relief Act of 1997

Congress substantially modified the TEFRA partnership audit rules in 1997 by creating a third category under the administrative system for partnerships – the "electing large partnership" regime – and also by liberalizing the TEFRA partnership audit rules in general.[79]

1. Electing Large Partnership Regime

Effective for taxable years beginning after December 31, 1997,[80] Congress created a new elective category of partnerships for purposes of both partnership reporting and partnership audit purposes – the electing large partnership ("ELP").

a. Simplified Flow Through Reporting

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[75] Pub. L. No. 100-647, 102 Stat. 3342 (1988).
[76] 1988 Act § 1018(o)(3).
[77] Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982). TEFRA had already been enacted by public law number 97-248 at the time the Subchapter S Revision Act of 1982 was enacted. *See supra* note 3.
[78] Small Business Jobs Protection Act of 1996, §§ 1307(c)(1) and (c)(3)(B), Pub. L. No. 104-88, 110 Stat. 1755 (1996).
[79] Taxpayer Relief Act of 1997, §§ 1221-1243, Pub. L. No. 105-34, 111 Stat. 788 (1997) [hereinafter 1997 Act].
[80] 1997 Act at § 1226.

In an effort to reduce the sheer number of items reported to partners and, thereby, ease the reporting burden of partners and facilitate matching by the Service,[81] Congress enacted a simplified flow-through reporting regime for electing large partnerships ("ELPs"). Subject to exclusions for personal service partnerships and commodity partnerships, an ELP is generally any partnership that elects under the provision if the number of partners in the preceding tax year is 100 or more.[82] For this purpose, partners performing substantial services in connection with the partnership's activities do not count.[83] The primary impact of the simplified flow-through regime was to reduce from "more than 40 items"[84] to slightly more than 10 items[85] reported to partners of ELPs.

b. Simplified ELP Audit Regime

One consequence of electing into the optional large partnership flow-through regime was to also be subject to the simplified flow-through reporting regime to a simplified ELP audit regime (*i.e.*, the simplified ELP audit regime[86] is part of a larger optional system that includes simplified flow-through reporting).[87] Recognizing that the existing audit procedures for large partnerships were inefficient and more complex than the audit procedures for other large entities,[88] the 1997 Act created a third category of partnerships – the ELP. Since then, there are three categories of partnership audits in the

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[81] STAFF OF THE JT. COMM. ON TAX'N, GENERAL EXPLANATION OF THE TAX LEGISLATION ENACTED IN 1997, p. 355 (1997) (JCS-23-97) [hereinafter 1997 BLUEBOOK].
[82] 1997 Act at § 1221.
[83] *Id.*
[84] *Id.*
[85] *Id.* at 355. Congress outlined ten items and also created an eleventh catchall category for the Service to designate any other items it believed warranted separate treatment. *Id.*
[86] Hereafter, the simplified ELP audit regime may be referred to as the ELP audit regime, the ELP partnership audit regime or the ELP regime.
[87] 1997 BLUEBOOK at 363 ("The provisions defines 'electing large partnership' the same way for audit and reporting purposes . . . .").
[88] *Id.*

United States: (1) audits of small non-TEFRA partnerships following the described above in effect prior to TEFRA; (2) audits under TEFRA; and (3) audits of ELPs.[89] Importantly, Congress identified as the source of inefficiency and complexity to be (1) the assessment of any deficiency against a large number of partners, (2) the difficulty in locating a large number of partners (many of whom are no longer partners) and (3) the ability of individual partners to intervene in the audit.[90]

While technically a subset of the TEFRA partnership audit rules, the ELP audit regime differs from the TEFRA audit regime in several important respects. For one, unlike under the TEFRA audit regime, partnership adjustments generally flow through to the partners for the year in which the adjustment takes effect (i.e., adjustments generally will not affect prior-year returns).[91] Also, in lieu of flowing an adjustment through to its partners, the partnership may elect to pay an imputed underpayment.[92] Regardless of whether an election is made to pay the tax due at the partnership level, the partnership, rather than the partners individually, is liable for any interest and penalties that result from a partnership adjustment.[93] Unlike under the TEFRA audit rules, under the ELP audit rules a partner is not allowed to take a position inconsistent with the partnership return even by filing a notice of inconsistent treatment with the Service.[94] Moreover, a single representative (who may be a non-partner) must be appointed (or, if not appointed, the

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[89] *See supra* note 15 and surrounding text.
[90] 1997 BLUEBOOK at 363.
[91] *Id.*
[92] *Id.* But if a partnership ceases to exist before a partnership adjustment takes effect, the former partners are required to take the adjustment into account, as provided in regulations. *Id.* at 364.
[93] *Id.* at 363.
[94] *Id.* at 364.

Service may designate any partner) to represent the partnership in all proceedings.[95] The Service will deal solely with the designated (or appointed) representative and no partner has the right individually to participate in settlement conferences or to request a refund.[96] Similarly, the Service is not required to give notice to individual partners of commencement of an administrative proceeding or of a final adjustment[97] and, while administrative adjustments can still be challenged in a trial court (*i.e.*, a court of first impression – being the U.S. Tax Court, the U.S. District Court, or the U.S. Court of Federal Claims),[98] only the partnership, and not the partners individually, can petition for a readjustment of partnership items.[99] Finally, absent an agreement otherwise and absent false or fraudulent returns, a substantial omission of income, or the failure to file a partnership return, the Service can not adjust a partnership item of an ELP more than three years after the later of the filing of the partnership return or the last day for filing the partnership return.[100]

2. Liberalization and Clarification of the TEFRA Partnership Audit Rules

a. Deficiency Proceedings and Oversheltered Returns -- Overrule of *Munro*

Partnership proceedings under TEFRA must be kept separate from deficiency proceedings involving the partners in their individual capacity. Historically, when the Service audited a partner's non-partnership items in a regular examination, it computed

[95] *Id.*
[96] *Id.*
[97] *Id.* In fact, the Service can give proper notice by mailing the notice to the last known address of the partnership, even if the partnership has since terminated its existence. *Id.*
[98] Those being the Tax Court, the Claims Court, or the U.S. district court in which the partnership's principal place of business is located. *Id.* at 365.
[99] 1997 BLUEBOOK at 365.
[100] *Id.*

any resulting deficiency by assuming that all partnership items were correctly reported on the partner's return. If a later TEFRA examination resulted in adjustments to partnership items and affected items, the Service would make computational adjustments to the partner's income as previously adjusted in the partner-level examination.[101] However, where the losses claimed from TEFRA partnerships were so large that they offset any proposed adjustments to non-partnership items, no deficiency could arise from a non-TEFRA proceeding.[102] For example, if a partner reported a loss from partnership items of $100 and a loss from non-partnership items of $200 for a combined loss of $300, then no deficiency could result unless non-partnership items were increased by more than $300. But, if partnership items were subsequently disallowed in a partnership proceeding, the non-TEFRA adjustments might be uncollectible because of the expiration of the statute of limitations with respect to non-partnership items.[103]

Faced with this situation in *Munro*,[104] the Service issued a notice of deficiency to the taxpayer that presumptively disallowed the taxpayer's TEFRA partnership losses for computational purposes only. Although the Tax Court ruled that a deficiency existed and that the court had jurisdiction to hear the case, the court disapproved of the methodology used by the Service to compute the deficiency. Specifically, the Court held that partnership items included on a taxpayer's return must be completely ignored in determining whether a deficiency exists that is attributable to non-partnership items.[105]

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[101] MCKEE, NELSON, WHITMIRE, HUFFMAN & WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS & PARTNERS ¶ 10.07 (online ed. Warren Gorham & Lamont 2014) [hereinafter MCKEE].
[102] 1997 BLUEBOOK at 369.
[103] *Id.*
[104] 92 T.C. 71 (1989).
[105] 1997 BLUEBOOK at 369.

For example, a taxpayer would be harmed if he has invested in a TEFRA partnership and is also subject to the deficiency procedures with respect to non-partnership item adjustments, since computing the tax liability without regard to partnership items will have the same effect as if the partnership items were disallowed.[106] If the partnership items were losses, a greater deficiency for non-partnership items would result. While the result is not catastrophic if the partnership proceedings were complete (because the taxpayer will be allowed any part of the partnership losses, which result in an overpayment at the individual level), in the interim time before the partnership proceeding is complete the taxpayer will have been subject to assessment and collection of a deficiency inflated by items still in dispute in the partnership proceeding.

Contrarily, the Service would be harmed if a taxpayer's income is primarily from a TEFRA partnership, since the Service may be unable to adjust non-partnership items such as medical expense deductions, home mortgage interest deductions or charitable contribution deductions because there would be no deficiency (under *Munro*, the income must be ignored).

Congress overruled *Munro* noting that the opinion in *Munro* and allowed the Service to return to its prior practice of computing deficiencies by assuming that all TEFRA items whose treatment has not been finally determined had been correctly reported on the taxpayer's return, thereby eliminating the need to do special computations that involve the removal of TEFRA items from a taxpayer's return.[107] Additionally, the 1997 Act provided a declaratory judgment procedure in the Tax Court for adjustments to an over-sheltered return. An over-sheltered return is defined as a return that shows no taxable income and a

[106] *Id.*
[107] *Id.* at 370.

net loss from TEFRA partnerships.[108] In such a case, the Service is authorized to issue a notice of adjustment with respect to non-TEFRA items, notwithstanding that no deficiency would result from the adjustment, but only if such a notice of deficiency would have arisen in the absence of the net loss from TEFRA partnerships.[109]

b. Determination of Audit Procedure Based on Partnership Return

As stated above, there are three different audit regimes under TEFRA after 1997.[110] Because the Service oftentimes found it difficult determining whether to follow the TEFRA partnership audit rules or the regular deficiency procedures, Congress provided that the Service can base its determination on the partnership's return for the year and which audit procedure the Service reasonably determines should apply.[111]

c. Statute of Limitations Modifications

Several changes were made to the provisions relating to statutes of limitation.[112] First, the suspension rule for filing of petitions in TEFRA cases was conformed to the general rule for non-TEFRA deficiencies under section 6503(a).[113] (Prior to the conforming change, the statute of limitations in a TEFRA proceeding was tolled only by filing a timely petition whereas in a deficiency case, the statue of limitations is tolled by the filing of any petition, regardless of whether the petition is timely filed.) Second, the 1997 Act clarified that the statute of limitations is suspended for a partner who is named in a bankruptcy

[108] *Id.*
[109] *Id.*
[110] *Supra* note 15 and surrounding text and note 89 and surrounding text.
[111] 1997 BLUEBOOK at 371.
[112] *Id.* at 371-374.
[113] *Id.* at 372.

petition.[114] Finally, the Service was authorized to rely on an extension of the statute of limitations under section 6229(b)(1)(B) by a TMP even if the TMP was a debtor in bankruptcy at the time the extension was executed unless the Service has been notified of the bankruptcy proceeding in accordance with regulations prescribed by the Secretary.[115] Congress noted that the Service is not automatically notified of bankruptcy filings and cannot easily determine whether a TMP is in bankruptcy.[116]

d. Changes to the Scope of TEFRA: Small Partnership Exception

TEFRA exempts from the TEFRA partnership audit rules partnerships consisting of 10 or fewer partners (the "small-partnership exception"). Historically, the small-partnership exception did not apply if any of the 10 partners was other than (1) a natural person or (2) an estate.[117] The 1997 Act liberalized this rule by allowing partnerships with C corporation partners to qualify for the small partnership exception.[118]

e. Other Miscellaneous changes

The 1997Act made several other changes to the TEFRA audit proceedings including exclusion of partial settlements from 1-year statute of limitation on assessments for partnership items that convert to non-partnership items under section 6229(f);[119] conforming the TEFRA rule to the non-TEFRA rule under section 6511(c) such that an agreement extending the statute of limitations in a TEFRA proceeding also extends the

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[114] *Id.* Prior to this amendment, it was unclear whether section 6503(h), which provides for the suspension of the limitations period during the pendency of a bankruptcy proceeding, applied to a TEFRA proceeding. *Id.* at 372-373.
[115] *Id.* at 374.
[116] *Id.* at 374.
[117] TEFRA at § 402(a).
[118] 1997Act at § 1234(a).
[119] 1997 BLUEBOOK at 375.

statute to file a refund claim;[120] determining the applicability of penalties at the partnership level, but with each partner being allowed to raise any partner level defenses in a refund forum;[121] clarifying that an action to enjoin premature assessments of deficiencies attributable to partnership items may be brought in the Tax Court;[122] and treating premature petitions filed by certain partners within the 90-day period as being filed on the last day of the following 60-day period under specified circumstances, thus affording the partnership with an opportunity for judicial review that was not available under prior law.

G. IRS Restructuring and Reform Act of 1998

Under prior law, the Service was not required to notify the partners if it selected an new TMP pursuant to section 6231(a)(7) even thought the TMP is required under TEFRA to keep each partner informed of all administrative and judicial proceedings with respect to the partnership. Congress was concerned that, in cases where the Service designates the TMP, that the other partners may be unaware of such designation[123] and, thus, required the Service to notify all partners of any resignation of the TMP, and to notify the partners of any successor TMP.[124]

IV. Judicial Highlights of TEFRA: How Have the Government and Taxpayers Fared Under TEFRA?

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[120] *Id.* at 376.
[121] *Id.* at 377.
[122] *Id.* at 378.
[123] STAFF OF THE JT. COMM. ON TAX'N, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1998, at p. 119 (1998) (JCS-6-98).
[124] *Id.*

To say that TEFRA has generated substantial judicial activity would be a gross understatement.[125] Throughout its more than 30 years of existence, TEFRA has generated massive amounts of litigation over the meaning of its provisions.[126] This Part will examine a few of the primary areas of controversy between taxpayers and the government under TEFRA with an eye toward how the taxpayers and the government have fared.

A. Notice Requirements

In a TEFRA partnership audit, there are three levels of notice obligations related to administrative and judicial proceedings.

1. Service's Required Notice

The Service is required to send notice to each identified partner (other than partners owning a very small interest in a partnership with more than 100 partners[127]) of the beginning and completion of the administrative proceedings[128] and the notice upon completion of the administrative proceeding must not occur before 120 days after notice of the beginning of the administrative proceeding occurs.[129] However, because the only remedy to a partner not receiving the notice of the beginning of the administrative

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[125] *See*, *e.g.*, Irvine v. United States, petition of writ of certiorari, at p.16, *reproduced at* 2014 TNT 61-25 (February 24, 2014), *cert. denied*, 134 S.Ct. 1777 (March 31, 2014) (stating in the statement of the case that the TEFRA rules "continue to divide the circuits 30 years after TEFRA's enactment") (citation omitted); United States v. Woods, 134 S. Ct. 557 (2013) (No. 12-562) (decided less than three months before *Irvine*). Considering that approximately 10,000 petitions for a writ of certiorari are filed with the Supreme Court of the United States each year and that it accepts about 75-80 cases (a less than 1% acceptance rate), it speaks volumes about the problems generated by TEFRA for a taxpayer to petition for a writ of certiorari within three a three-months following the Court's ruling in another TEFRA case. *See* Supreme Court of the United States, Frequently Asked Questions (FAQ), at http://www.supremecourt.gov/faq.aspx#faqgi9 ("How many cases are appealed to the Court each year and how many cases does the Court hear?").
[126] *Id.*
[127] Section 6223(b).
[128] Section 6223(a).
[129] Section 6223(d)(1).

proceeding is to elect out of the TEFRA proceeding (thereby converting all partnership items to non-partnership items)[130] and because such an election triggers a new one-year statute of limitations for such converted items,[131] the Service has little fear of failing to notify partners of the beginning of the administrative proceeding. Moreover, failure of the Service to notify partners of the beginning of an administrative proceeding does not invalidate the final partnership administrative adjustment ("FPAA") sent to notify partners at the end of the administrative proceeding.[132] Thus, failure to notify partners of the beginning of the administrative proceeding apparently has no impact on the validity of a timely issued FPAA.[133]

Courts have also held, for example, that the FPAA need not take any particular form and that an FPAA must "minimally give notice to the taxpayer that the Service has finally determined adjustments to the partnership return,"[134] that a generic notice addressed to "THE TAX MATTERS PARTNER" was valid and adequate even though a TMP had been designated to the Service by name and address,[135] that an FPAA mailed to the TMP at the address shown on the return under audit was valid even though the TMP had a different

[130] Section 6223(e)(3)(B).
[131] Section 6223(f)(1).
[132] *See*, *e.g.*, Wind Energy Technology Associates III v. Commissioner, 94 T.C. 787 (1990) (the Code does not define a timely FPAA with reference to the Service's notice of the beginning of an administrative proceeding – notice of beginning of the administrative proceeding issued one week prior to the FPAA) and White and Case v. United States, 22 Cl. Ct. 734 (1991) (same – notice of the beginning of the administrative proceeding issued three days prior to the FPAA).
[133] The FPAA must be mailed before the expiration of the statute of limitations. *See* the discussion of statute of limitations below in Part IV.B.
[134] Clovis I v. Commissioner, 88 T.C. 980 (1987) (equating an FPAA to a statutory notice of deficiency, which does not require any particular form).
[135] Triangle Investors Ltd. Partnership v. Commissioner, 95 T.C. 610 (1990).

address in the return for the following tax year,[136] and that an FPAA need not contain any reasoning for the underlying adjustments.[137]

Failure by the Service to timely notify the TMP (and other partners entitled to notice) of the FPAA, however, is more serious and is more a statute of limitations issue. As such, this issue will be discussed below in Part IV.B.

2. Partners' Required Notice

There are two different notice requirements for partners – one for the TMP[138] and another for so-called pass-through partners.[139]

a. Tax Matters Partner's Required Notice

The TMP is required, to the extent provided in regulations, to keep the other partners informed of all administrative and judicial proceedings for the adjustment at the partnership level of partnership items.[140] There is, however, no penalty imposed on the TMP for failure to fulfill this obligation, and the TMP's failure to provide notice or perform any act required by TEFRA (or the regulations promulgated thereunder) does not affect the applicability of any IRS proceeding or adjustment to the other partners under TEFRA.[141]

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[136] Taurus FX Partners, LLC v. Commissioner, TC Memo 2013-168.
[137] Austin Inv. Fund, LLC v. United States, 2009-1 USTC 50,173 (unpublished opinion).
[138] Section 6223(g).
[139] Section 6223(h).
[140] Section 6223(g).
[141] Section 6320(f) ("The failure of the tax matters partner, a pass-thru partner, the representative of a notice group, or any other representative of a partner to provide any notice or perform any act required under this subchapter or under regulations prescribed under this subchapter on behalf of such partner does not affect the applicability of any proceeding or adjustment under this subchapter to such partner.") This Draconian rule against the small partners, in part, led one commentator to question whether "the small partner was left out" under TEFRA. ROSEN *supra* note 54 (suggesting that a regime similar to the class action lawsuit regime would better serve small partners in TEFRA partnerships). *See also* Kaplan v. United States, 133 F.3d 469 (7th Cir. 1998) (a less than one percent partner who did not receive notice as required from the TMP but who paid tax

b. Pass-Through Partner's Required Notice

Finally, TEFRA requires certain pass-through partners[142] to forward a copy of any notice it receives from either the Service or the TMP within 30 days of receipt to person(s) holding an interest (through the pass-through partner) in the profits or losses of the partnership to which the notice relates.[143]

On balance, most of the court decisions regarding notice discussed above favor the Service. So long as the partner notifies those partners identified to it by the TMP, then it is absolved from any wrongdoing even if the TMP failed to identify a partner entitled to notice or even if the TMP or a pass-through partner fails to perform the duties under TEFRA and notify the other partners.

B. Statute of Limitation Requirement

On its face, the section 6229 seems simple enough. Absent the filing of a partnership return that contains a false or fraudulent item,[144] section 6229(a) generally provides that the statute of limitations to assess any tax attributable to a partnership item or an affected item for a partnership tax year expires three years after the later of the date on which the partnership return for such tax year was filed or the last day for filing such return for such

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under protest cannot file a refund suit because section 7422(h) deprives courts of jurisdiction over partnership items except as otherwise provided – the court held that lack of personal notice did not violate equal protection or due process clauses of the U.S. Constitution) and Walthall v. United States, 131 F.3d 1289 (9th Cir. 1997) (notice provisions not unconstitutional).

[142] A pass-through partner is any pass-through entity (*i.e.*, a partnership, estate, or trust) that owns an interest in the partnership.

[143] Section 6223(h).

[144] Section 6229(c). Additionally, if a partner either signed or participated directly or indirectly in the preparation of the partnership return containing the false or fraudulent item with the intent to evade tax, then the statute never expires with respect to such partner. Section 6229(c)(1)(A). With respect to all other partners, the statute is extended from three to six years for all other partners reporting items pursuant to such false or fraudulent return. Section 6229(c)(1)(B).

year (without regard to extensions). This period may be extended either by agreement of the Service and (1) a particular partner, in which case it is binding only on the agreeing partner, or (2) the TMP, in which case it is binding on all partners. Once an FPAA is mailed to the TMP, the period of limitations is suspended for the period during which a judicial review may be brought under section 6226 (and until the decision of the court becomes final if a judicial review is brought) and for one year thereafter.[145] A special rule extends the statute of limitations with respect to a partner if either (1) such partner was not identified to the Service prior to the time the Service mails an FPAA to the TMP before the normal three-year statute of limitations expires or (2) if a partner files inconsistently with the Schedule K-1 provided by the partnership. In such case, the statute of limitations is suspended until at least one year after the date on which this information is given to the Service.[146] Finally, if partnership items become non-partnership items, then the period of limitations does not expire until at least one year after the date on which the partnership items became non-partnership items.

However, despite its innocuous appearance, the TEFRA assessment deadline (*i.e.*, statutes of limitation rules) has been labeled as "without question, TEFRA's most litigated and significant unresolved issue of statutory interpretation."[147] One commentator suggested, more than eight years ago, that more than 10,000 hours and $100 million in fees and other costs has been spent studying, auditing, and litigating the correct meaning of

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[145] This one-year extension of the statute of limitation is likely necessary to allow the Service time to assess tax against each individual partner after the partnership level adjustment has been resolved whether finally resolved based on the FPAA, a settlement, or litigation.
[146] Section 6229(e).
[147] Irvine v. United States, petition of writ of certiorari, at p.16, *reproduced at* 2014 TNT 61-25 (February 24, 2014), *cert. denied*, 134 S.Ct. 1777 (March 31, 2014).

section 6229.[148] The same commentator made the following observation regarding the effort undertaken by the U.S. Court of Claims to find the right meaning of section 6229:

> There is something wrong when, to understand one sentence in a statute, one must consult 10 different cases, adopt or discard several canons of construction – including the plain meaning rule and various presumptions for and against the taxpayer – sift through committee reports enacted both concurrently with and after the statute, sit on congressional colloquies, discredit a contemporaneous *Bluebook* explanation, and then read another statute never sufficiently referenced by the first statute.[149]

Most of the confusion, and litigation, arises over whether two different statutes of limitation periods – the section 6229 partnership-level statute governing partnership and affected items and the general statute (contained in sections 6501-6504) governing non-partnership items on each partner's separate return – should be applied in isolation or in conjunction. The result is an ongoing fight between taxpayers and the Service regarding the interaction of the TEFRA statute of limitations and the partner-level statute of limitations (*i.e.*, whether section 6229 should be read in isolation or whether the Service may also rely on the partner's personal statute of limitations under sections 6501-6504 in connection with TEFRA partnership audit proceedings).

In an effort to extend the TEFRA statute of limitations, the Service began arguing that section 6229 is not a mutually exclusive statute of limitations in TEFRA partnership audit proceedings, governing partnership and affected items, but that it operates in tandem with the normal limitation period set forth in section 6501, governing non-partnership

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[148] Darryll K. Jones, *The Labyrinthine and Expensive Partner Limitations Period*, Tax Notes, August 21, 2006 [hereinafter Jones]. No doubt those estimates are much higher today – eight years later.

[149] *Id.* The commentator made the statement in connection with the commentator's reading of the U.S. Court of Claims decision in AD Global Fund LLC v. United States, 67 Cl. Ct. 657 (2005), *aff'd*, 481 F.3d 1351 (Fed. Cir. 2007).

items, by merely extending the individual assessment period of section 6501.[150] Soon after, the Tax Court faced the issue in *Rhone-Poulenc*.[151] In a complicated reviewed opinion in which 14 judges participated, the Tax Court issued four separate opinions.[152] In the end, 11 judges sided with the government holding that section 6229 is not mutually exclusive uniform statute of limitations that applies to all partners, but instead merely serves to provides an alternative minimum period for assessment applicable to all partners.[153] Since then, several other courts have agreed on the issue.[154] The exact parameters of the statute of limitations for TEFRA partnership audit proceedings, however, remains unclear.[155]

Notwithstanding the government's victory in *Rhone-Poluenc*, the ambiguous statute of limitation rules serves to instill fear in the government of missing a statute of limitations and operates as foot fault.[156] For example, any partner identified to the Service 30 days or more prior to the date the Service mails the notice of the beginning of an administrative proceeding or an FPAA to the TMP is entitled to receive the FPAA directly from the

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[150] LGM 199905040 (Sept. 25, 1998) ("It is our position that section 6501 is the controlling limitation on assessment, and that to the extent applicable, section 6229 merely serves to extend the section 6501 general limitation on assessment. In effect, the limitation on assessment of tax attributable to partnership items is the longer of section 6501 or section 6229.")
[151] Rhone-Poulenc Surfactants & Specialties, LP v. Commissioner, 114 T.C. 533 (2000).
[152] *Id.*
[153] *Id.*
[154] Andantech LLC v. Commissioner, 331 F3d 972 (DC Cir. 2003) (following *Rhone-Poulenc*); AD Global Fund, LLC v. United States, 481 F3d 1351 (Fed. Cir. 2007) (same); Curr-Spec Partners, L.P. v. Commissioner, 579 F3d 391 (5th Cir. 2009), *cert. den'd* (same); Shcumacher Trading Partners II v. United States, 72 Cl. Ct. 95 (2006) (same); Grapevine Imports, Ltd. V. United States, 71 Cl. Ct. 324 (2005) (same); and Kligfeld v. Commissioner, 128 T.C. 192 (2007) (same).
[155] *See*, *e.g.*, Epsolon Ltd. v. United States, 78 Cl. Ct. 738, 760 (2007) (FPAA issued after the section 6229 period had expired held timely because the section 6501 statute of limitations for one partner had been suspended under section 7609(e), relating to delays in the final resolution of the production of information sought via third-party summonses).
[156] *See infra* Denis Conlon Interview, note 202.

Service.[157] The Service's failure to do so would result in violating the statute of limitations. The Service must also be careful to make sure the TMP is qualified to extend the statute of limitations.[158] The Service could inadvertently violate a statute of limitations if it continued to deal with a TMP after the TMP became disqualified.

C. Partnership/Affected Item Issues

In the C corporation world, all things tax are determined at the entity level even though those determinations will impact the value of each shareholder's stock. No shareholder, however, is given a direct say in the tax determinations at the corporate level (unless the shareholder happens to be the chief financial officer or other person directly involved in tax matters on behalf of the corporation). The Code simply does not protect any individual shareholder rights in tax matters.

At the time TEFRA was being conceived, the government issued a proposal to treat a partnership as an entity for purposes of auditing the partnership.[159] Commentators argued,

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[157] Section 6223(e).

[158] *See*, *e.g.*, Transpac Drilling Venture 1982-12 v. Commissioner, 147 F.3d 221 (2d Cir. 1998) (TMP disqualified and extension of statute of limitations declared invalid because of a conflict of interest where the Service was conducting a criminal investigation of the TMP); Treas. Reg. § 301.6231(a)(7)-1(l)(1) (TMP designation automatically terminates upon TMP's death or adjudication of incompetency of an individual, upon the liquidation of a non-individual, or if TMP's partnership items are converted to non-partnership items); and Treas. Reg. § 301.6231(a)(7)-7(a) (a TMP's partnership items are automatically converted to non-partnership items on the date the TMP files a petition in bankruptcy, thereby terminating the TMP's designation as such).

[159] *See* 1978 TAX PROGRAM at 129 (noting that the Service will make determinations at the partnership level of both the correct amount of partnership taxable income and the partners' distributive shares of partnership items and that the entity-level determination will be conclusive on both the partners and the Service and that both would be precluded from seeking any further substantive review). Moreover, the government proposed that only the partnership be allowed to (1) seek a redetermination of the partnership items following an audit (by filing an amended return within the limitations period) and (2) seek judicial review of a final partnership determination. *Id.* at 130.

however, that individual partner rights must be respected.[160] The TEFRA partnership audit rules apply both the entity and aggregate views of partnership taxation to a single issue – audits of partnerships. TEFRA attempts to achieve this goal by dividing a single partnership into two worlds – an entity world (with respect to "partnership items") and an aggregate world (with respect to "affected items" and "non-partnership items") – and attempts to both protect the rights of individual partners while also providing a unified audit procedure with respect to partnership items of certain partnerships.

Congress defined a "partnership item" under TEFRA as any item required to be taken into account for the partnership's taxable year but then authorized Treasury to determine which particular items are "more appropriately" determined at the partnership, rather than the partner, level.[161] An "affected item" is any item to the extent it is affected by a partnership item.[162] A "non-partnership" item is any item that is not (or is not treated as) a partnership item.[163] The U.S. Treasury has promulgated regulations defining

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[160] 1979 ABA PROPOSAL at 552 (arguing that:

> At the same time, the government's original proposals did not take sufficient account of the rights of dissenting partners, and it is important that statutory changes accommodate, protect and preserve these rights. In short, no matter what policy and procedural changes may otherwise be wrought, individual partners in these partnerships should be allowed to participate fully in the administrative and judicial processes; to take a position different from that of a general partner or a designated partner representing the partnership; to dissent in certain important situations; and to reflect that dissent in a judicial forum which does not demand prepayment of tax as a condition of jurisdiction.)

[161] Section 6231(a)(3) and 1982 Conference Report at 609.

[162] Section 6231(a)(5) and 1982 Conference Report at 609. Because partnerships do not pay tax, any change to a partnership item will flow through and impact items on the individual partner's return. Those items impacted by the flow through of partnership items are affected items.

[163] Section 6231(a)(4).

"partnership item"[164] and "affected item."[165] Although the statute of limitations for an affected item is held open to the same extent as a partnership item,[166] only partnership items (but not affected items or non-partnership items) are determined at the partnership level in a TEFRA audit proceeding.[167]

As if this regime were not already complicated enough, the Tax Court[168] has further divided affected items into separate categories: (1) items substantively related to items reflected on the TEFRA partnership return[169] and (2) items completely unrelated to the partnership items except on a computational basis.[170]

Congress did not elaborate regarding why it created the separate category of "affected items." Apparently, Congress created the separate "affected item" category to hold open the statute of limitation on the individual partner return with respect to the affected item until after the TEFRA partnership audit had been completed.[171] In this regard, a TEFRA partnership audit is a two-stage proceeding. First, the Service initiates a proceeding at the partnership level to adjust partnership items[172] and issues an FPAA

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164 Treas. Reg. § 301.6231(a)(3)-1.
165 Treas. Reg. § 301.6231(a)(5)-1.
166 Section 6229(a).
167 Section 6221.
168 N.C.F. Energy Partners, et. al. v. Commissioner, 89 T.C. 741, 744 (1987).
169 For example, a partner's outside basis in the partner's partnership interest.
170 For example, any floor or ceiling limitation for items of deduction reported on Form 1040, Schedule A (Itemized Deductions) based on a taxpayer's adjusted gross income.
171 Section 6229(d) (holding open the statute of limitation for affected items until 1 year after the expiration of the time during which the TMP or another partner may bring an action for judicial review of an issued FPAA). *See also* Steven R. Mather & Kajan Mather, Audit Procedures for Pass-Through Entities, TMP 624-2nd (Bloomberg BNA) (stating with no citation to any authority that "[t]he affected item category is essentially a means for implementing a special statute of limitations rule" and that "[t]he affected item category was created to resolve statute of limitations problems for items like the medical deduction").
172 Section 6221.

notifying the partners of any adjustments to partnership items.[173] Partners may then seek judicial review of those adjustments.[174] Only after the adjustments to the partnership level items have become final may the Service undertake further proceedings at the partner level to make any resulting "computational adjustments" in the tax liability of an individual partner.[175] Partner-level issues, including affected items, can only be handled in a separate non-TEFRA proceeding and only once all partnership-level proceedings are final. Courts in in TEFRA partnership audit proceedings have consistently held that the court has jurisdiction only over partnership, but not affected and non-partnership, items.[176] Similarly, courts in partner-level proceedings do not have jurisdiction to consider matters involving partnership items unless and until partnership items have been converted to non-partnership items.[177]

Also, a different statute of limitation rule may apply with respect to partnership items and affected items, on the one hand, and non-partnership items, on the other hand.[178] Thus, much litigation regarding whether an item is a partnership or affected item versus a non-partnership item arises because of the different statutes of limitation rules that may govern the two different categories of items.[179] If a taxpayer is able to convince a court that a particular item is a non-partnership (or a partnership or affected item, depending on the

[173] Section 6223(a)(2).
[174] Section 6226(a)-(h).
[175] Section 6231(a)(6). *See* Maxwell v. Commissioner 87 T.C. 783, 792 (1986).
[176] Section 6221. *See also*, *e.g.*, United States v. Woods, 134 S.Ct. 557 (2013) (deciding whether the U. S. District Court had 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).
[177] Section 6231(b).
[178] *See* Part IV.B immediately above (discussing the confused state of the law regarding the proper statute of limitations).
[179] *Id.*

particular facts) and the statute of limitations has already run on the non-partnership (or partnership or affected item), then the Service may be barred by the expired statute of limitation from proceeding against the taxpayer.

Despite an extensive list of partnership and affected items in the regulations,[180] taxpayers and the Service have disagreed numerous times regarding whether an item is a partnership item or an affected item.[181] Some of the items that courts have ruled to be partnership items[182] include whether a partner is a partner in a TEFRA partnership,[183] when a partnership terminates under section 708(b)(1)(A),[184] whether a partnership is a sham or lacks economic substance,[185] a provisional determination of the applicability of any penalty that could result from an adjustment to a partnership item (even though imposing the penalty requires a subsequent, partner-level proceeding),[186] and a partner's outside basis in a partnership interest, but only if the partnership under examination is deemed a sham.[187] Some of the items that courts have ruled to be affected items include the basis of securities distributed from a disregarded sham partnership,[188] adjusted gross income floors and ceilings for purposes of itemized deductions reported on Form 1040,

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180 Treas. Reg. § 301.6231(a)(3)-1 and Treas. Reg. § 301.6231(a)(5)-1.
181 McKee at ¶ 10.02[3] ("The definition of 'partnership item' has engendered considerable litigation").
182 For a more complete list of items addressed by the courts, *see* McKee at ¶ 10.02[3] and Arthur B. Willis, John S. Pennell & Philip F. Postlewaite, Partnership Taxation ¶ 20.02 (online ed. Warren Gorham & Lamont 2014).
183 Blonein v. Commissioner, 118 T.C. 541 (2011) (refusing to consider in a partner-level proceeding whether the person was a partner in a TEFRA partnership).
184 Harbor Cove Marina Partners Partnership v. Commissioner, 123 T.C. 64 (2004).
185 U.S. v. Woods, 134 S.Ct. 557, 563 (2013) (noting both sides agree with this premise).
186 *Id.* at 565.
187 *Id.* at 565-566 and Greenwald v. Commissioner, 142 T.C. No. 18 (2014).
188 Napoliello v. Commissioner, T.C. Memo 2009-104 (CCH) (May 18, 2009).

Schedule A,[189] a partner's at-risk amount,[190] and a partner's outside basis in a partnership interest.[191]

Not surprisingly, U.S. House of Representatives Committee on Ways and Means Chairman Camp recently proposed, as part of a proposal to repeal and replace the TEFRA partnership audit rules, to eliminate the distinction between partnership, non-partnership and affected items.[192]

V. Critique of TEFRA: What TEFRA Does and Does Not Do Well

A. What TEFRA Does Well

Despite some imperfections, the TEFRA partnership audit rules do some things very well.

1. Mandates Consistent Reporting Between the Partnership and Each Partner

The TEFRA partnership audit rules require that each partner's tax treatment of partnership items must be consistent with the treatment of those items at the partnership level. The requirement protects the Service from potential abuse by taxpayers. The consistency requirement furthers the tax policies of fairness (by ensuring each partner is treated the same) and simplicity/ease of administration (by protecting the Service from

[189] Maxwell v. Commissioner 87 T.C. 783, 792 n.7 (1986) and N.C.F. Energy Partners, et. al. v. Commissioner, 89 T.C. 741, 744 (1987).
[190] Roberts v. Commissioner, 94 T.C. 853 (1990).
[191] Greenwald v. Commissioner, 142 T.C. No. 18 (2014) (but only under the facts of that case – the court went to great lengths to distinguish its holding from the Supreme Court holding in Woods).
[192] 2014 CAMP PROPOSAL at 255.

potential whipsaw by different partners in a partnership taking different positions). Even TEFRA's most staunch critics admit this rule serves an important purpose.[193]

2. Theoretically Allows Each Partner to Deal with One Person and Audit One Entity

A key goal of TEFRA was to allow a partnership to be treated as an entity for purposes of partnership audit-related issues, including administrative settlement and judicial review.[194] An entity level audit should, theoretically, allow each Partner to deal with one person at the Service in connection with a TEFRA audit.

B. What TEFRA Does Not Do Well

Notwithstanding a few items the TEFRA partnership audit rules do well, on the whole, they fail in many respects.

1. Practical Impact of TEFRA Audits: Taxpayers Must Deal with Multiple Service Personnel

Despite the stated goal of TEFRA to achieve an entity-level audit, which presumably would result in a single point of contact for each partner in dealing with the Service in connection with a TEFRA partnership audit, anecdotal evidence indicates that this is not the case. At least two prominent partnership tax practitioners have provided an account of either (1) having to deal with multiple Service personnel in connection with a TEFRA partnership audit or (2) the Service never providing follow-up despite the audit having been completed. [I am awaiting approval to send out a survey to select partnership tax professionals. I will augment this section with the survey results.]

2. Reluctance of IRS Agents to Conduct TEFRA Audits

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[193] Prescott at 505 ("Only the requirement that each partner must report the tax consequences of the partnership's activities in a manner that is consistent with the partnership's return, or notify the IRS of the partner's inconsistency, should survive.").
[194] 1978 TAX PROGRAM at 129.

Despite TEFRA's goal of making audits of large partnerships[195] more efficient,[196] the extremely low rate of large partnership audits reported in the recent study by the U.S. General Accountability Office suggests that Service auditors are reluctant to conduct TEFRA audits.[197] Specifically, the GAO found that during fiscal year 2012, the Service closed 84 field audits of large partnerships – a 0.8 percent audit rate.[198] During that same time period, the Service closed 27.1 percent of C corporations with $100 million or more in assets.[199] Anecdotal evidence supports this conclusion -- practitioners generally know that the Service does not want to conduct TEFRA partnership audits.[200] One key reason given why the Service is reluctant to conduct TEFRA partnership audits is the complicated and ambiguous statute of limitation rules for TEFRA partnership audits.[201]

3. Statutes of Limitations of Partners and Partnerships

As was discussed above in Part IV.B., no area of TEFRA has produced more litigation than its statute of limitation rule. Much of the ambiguity and litigation arises because of the overlap of the TEFRA statute of limitation with the individual partner statute of limitation.

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195 For purposes of the GAO study, a large partnership is one with at least 100 direct or indirect partners and at least $100 million in assets. GAO FINAL REPORT at 1.

196 *See* 1982 Bluebook at 268. *See also* REG-138326-07, 74 Fed. Reg. 7205-01 (Proposed Treasury Regulations) ("One of the principal purposes behind the enactment of the TEFRA partnership procedures was to provide for the more efficient use of the IRS's resources by reducing multiple proceedings with respect to partnership items.").

197 GAO FINAL REPORT at 19-20, Table 4.

198 *Id.*

199 *Id.*

200 Telephone interview with Denis J. Conlon, Of Counsel, Martin, Brown, Sullivan, Roadman & Hartnettt, Ltd. (formerly Director IRS Controversy, Great Lakes Region, Ernst & Young LLP (11 years); and formerly Regional Counsel, Midwest Region, Office of Chief Counsel, IRS; District Counsel, Chicago, Office of Chief Counsel, IRS; Assistant Regional Counsel, Tax Litigation, Office of Chief Counsel, IRS; and Staff Assistant to Regional Counsel, Office of Chief Counsel, IRS (total of 34 years)) (Oct. 21, 2014) [hereinafter Denis Conlon Interview].

201 Denis Conlon Interview (Mr. Conlon suggested that missing a statute of limitations would likely be a career-ending event for an IRS auditor).

Moreover, as was also stated above, the exact parameters of the statute of limitations for TEFRA partnership audit proceedings remains unclear.[202]

4. Partnership/Affected Items

As was discussed in Part IV.C. above, much litigation has arisen under TEFRA regarding whether particular items were partnership items, affected items or non-partnership items. Oftentimes, a facial disagreement between the taxpayer and the Service over whether an item is a partnership or an affected item is actually a fight over which statute of limitation applies. Continued taxpayer-Service disputes no doubt led Chairman Camp to propose to eliminate the distinction entirely in his recent tax reform proposal.[203]

5. Identifying the TMP

Despite the central role played by the TMP in a TEFRA partnership audit, surprisingly, a partnership subject to the TEFRA audit procedures is not required to list the TMP on the partnership return.[204] Service focus groups informed the GAO that one of the primary challenges when conducting a TEFRA partnership audit is identifying the TMP.[205] Moreover, the burden for ensuring that the TMP meets the requirements of TEFRA largely falls on the IRS.[206] Service focus groups also informed the GAO it could take weeks or months to identify a qualified TMP.[207]

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[202] *See supra* note 156.
[203] 2014 CAMP PROPOSAL at 255.
[204] GAO FINAL REPORT at 27.
[205] UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, TESTIMONY BEFORE THE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, U.S. SENATE, LARGE PARTNERSHIPS: GROWING POPULATION AND COMPLEXITY HINDER EFFECTIVE IRS AUDITS 15, GAO-14-746T, July 22, 2014 [hereinafter GAO SENATE TESTIMONY]. Very generally a service focus group is a group of employees of the Internal Revenue Service interviewed by the GAO.
[206] *Id.*
[207] *Id.*

6. Tiered Partnership

A tiered partnership is a partnership in which at least one pass-through entity owns an interest in the partnership. A pass-through entity that owns an interest in a partnership is often referred to as a pass-through partner.[208] An owner of a pass-through entity that is a partner in a partnership is referred to as an indirect partner. Where the pass-through entity partner is another partnership, the bottom (or lower) partnership is referred to as a lower-tier partnership (with respect to a higher partnership) and the top (or higher) partnership is referred to as an upper-tier partnership (with respect to a lower partnership). Taxpayers employ tiered partnership structures for a number of business reasons – usually to isolate liabilities.

As was stated above, Congress recognized prior to the enactment of TEFRA that tiered partnership structures present many unique issues in connection with partnership audits.[209] Yet despite Congress' recognition of the problems caused by tiered partnership structures, the TEFRA audit rules do not appear to be working to resolve many, if any, of the issues identified.

For example, tiered partnership structures continue to flourish post-TEFRA. In 2011 more than two-thirds of large partnerships had at least 100 or more pass-through entities and 36 percent had at least 1,000 or more pass-through entities as direct and indirect partners.[210] Tiered partnership structures hinder the Service's ability to identify

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[208] Section 6223(h).
[209] *See supra* note 35 and surrounding text. 1978 TAX PROGRAM at 129 ("Such multi-tiered arrangements substantially increase the Service's burden of locating individual partners and auditing their returns within the requisite statute of limitations period.").
[210] GAO FINAL REPORT at 16. According to the GAO, there is some evidence that large partnership structures are becoming more complex. In tax year 2011, 78 percent of the large partnerships had six or more tiers compared to 68 percent in tax year 2012. *Id.*

the ultimate tax-paying (indirect) partner in the underlying partnership (so that any adjustments can be passed through to the ultimate tax paying partner's return(s)).[211] They also make it difficult for the Service to determine in which entity a given partnership item arose.[212] Tiered partnership structures also complicate the relationships and allocations of income and losses within a large partnership structure[213] thereby making it more difficult for the Service to audit large partnerships with tiered structures within the prescribed statute of limitations period.

Thus, notwithstanding Congress' awareness of the proliferation of multi-tiered partnerships prior to the enactment of TEFRA and Congress' focus on the problems they created, the TEFRA audit rules do not appear to have helped the Service with issues arising when auditing tiered partnerships.[214]

VI. Reactions to TEFRA

A. Government Reactions to TEFRA

Since its enactment more than 30 years ago, both government and nongovernment stakeholders have reacted negatively to TEFRA. On the nongovernment side, after suggesting that the TEFRA partnership audit rules are no longer necessary because of improvements to substantive law and technology, one commentator recently argued, "the

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[211] *Id.*
[212] *Id.* at 24 ("IRS officials reported difficulty . . . knowing which entity in a tiered structure is generating the income or loss") and Cemco Investors, LLC v. United States, 515 F3d 749, 752-753 (2007) (arguing that an asset contributed to a partnership with a carryover basis is an item with respect to the contributing entity – not the partnership under audit).
[213] *Id.*
[214] For a discussion of navigating the TEFRA partnership audit rules in multi-tiered entities, *see* Mary A. McNulty, Robert D. Probasco & Lee S. Meyercord, Navigating TEFRA Partnership Audits in Multi-Tiered Entity Structures, Business Entities, January-February 2013, at p. 22.

TEFRA partnership audit rules should now be largely repealed."[215] As discussed in Part III above and in an attempt to correct certain shortcomings of the TEFRA partnership audit procedures, Congress has modified TEFRA numerous times since its original enactment in 1982 – the most significant of which occurred in 1997. Each modification was in response to a perceived shortcoming or ambiguity in the TEFRA partnership audit rules.

More recently, both the Obama Administration and the Chairman of the U.S. House of Representatives Committee on Ways and Means (Representative Dave Camp) have proposed further changes to the TEFRA partnership audit rules. The Obama Administration proposes to make the ELP partnership audit regime, but not the simplified flow through reporting regime, mandatory for any partnership that has 1,000 or more direct and indirect partners at any time during the year.[216] Representative Camp's proposal is more drastic and seeks to repeal TEFRA, including the ELP regime, and replace it with an entirely new partnership audit regime that generally applies to all partnerships unless an election out is made, which would be available only to certain partnerships with 100 or fewer partners.[217] Very generally, though, the Camp proposal tracks in many important regards the ELP partnership audit regime (including assessing any underpayment of tax arising from audit adjustments at the partnership level). One key difference from existing rules, however, is a proposal to eliminate the distinction between a partnership item, an affected item, and a non-partnership item. Instead, under the Camp proposal, all items would be determined at the partnership level.[218]

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[215] PRESCOTT at 505.
[216] 2014 GREEN BOOK at 218.
[217] 2014 CAMP PROPOSAL at 255.
[218] *Id.*

Finally, the U.S. Government Accountability Office ("GAO"), responding to a request from Congress to assess the Service's ability to audit large partnerships, published a number of documents during 2014 addressing the need for the Service to improve audit efficiency in audits of larger partnerships.[219] The GAO also published a report during 2014 addressing noncompliance issues relative to all partnerships.[220] The GAO reports attribute some fault to the Service, including its poor tracking of larger partnership audit results, failure to exercise existing regulatory authority to identify a TMP, failure to provide counsel staff, TEFRA coordinator and IRS specialist support to field auditors, and failure to communicate when field auditors can access refresher training on TEFRA audit procedures and partnership tax law.[221] In line with both the Obama Administration's and Representative Camp's proposals, the GAO Final Report recommended Congress amend the TEFRA partnership audit rules to require partnerships with a certain number of direct and indirect partners pay any tax owed as determined by the audit adjustments at the partnership level.[222] Finally, the GAO Final Report recommends that Congress mandate that partnerships designate a TMP and keep that designation up to date.[223]

The GAO Final Report appears to focus solely on auditing a partnership's taxable income or loss number and none discusses an even larger concern – auditing allocations of

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[219] UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, LARGE PARTNERSHIPS: CHARACTERISTICS OF POPULATION OF IRS AUDITS, GAO-14-379R, March 19, 2014 [hereinafter PRELIMINARY GAO REPORT]; GAO SENATE TESTIMONY; and GAO FINAL REPORT.
[220] UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, PARTNERSHIPS AND S CORPORATIONS: IRS NEEDS TO IMPROVE INFORMATION TO ADDRESS TAX NONCOMPLIANCE, GAO-14-453, May 14, 2014 [hereinafter GAO GENERAL PARTNERSHIP REPORT].
[221] GAO FINAL REPORT at 39.
[222] *Id.* at 38.
[223] *Id.*

partnership taxable income between or among the partners of the partnership.[224] As was stated earlier in Part II. A., because partnerships do not pay tax, the partnership return serves two key purposes: (1) report the accurate amount of total partnership taxable income or loss and make certain tax elections; and (2) allocate total partnership taxable income between or among the partners of the partnership. The accurateness of these allocations will dictate what amount of the partnership's total taxable income or loss must be included in each partner's own income tax return.

Along those same lines, although neither the Preliminary GAO Report nor the GAO General Partnership Report addressed the lack of auditor training or expertise regarding partnership matters, the GAO Final Report questioned Service focus groups about the issue and members of the focus groups reported that they have limited knowledge of technical tax issues for partnerships and that they may only work on a partnership audit once every few years.[225] It would be impossible for an auditor with little or no partnership expertise or experience to study and comprehend all of subchapter K and adequately audit the

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[224] Specifically, when discussing tiered partnership structures, the GAO Senate Testimony states as follows:

> IRS faces the daunting task of verifying that income is properly reported for tax purposes as it passes through the tiers and is ultimately *distributed* to the direct or indirect partners responsible for making tax payments.

GAO Senate Testimony at 1 (Emphasis added). Partners are not generally taxed on partnership distributions (unless the amount of a distribution exceeds the partner's outside tax basis) but are, instead, taxed on allocations of distributive shares of partnership income. Based on the context of the statement, the GAO appears to be discussing partnership allocations of distributive shares – not distributions. *See supra* note 16 for a discussion of the difference between a distribution and a distributive share.

[225] GAO FINAL REPORT at 32. The lack of technical expertise and experience among Service personnel charged with auditing partnership tax returns signals a much bigger issue relative to partnership audits in general in addition to issues specifically related to TEFRA partnership audits.

allocations of income, gain, loss, deduction and credit between or among the partners all within the period of a partnership audit (which the Final GAO Report suggests might be as little as 18 months[226]), especially where the partnership audit was not the only task on the auditor's desk at the time.

B. Non-Government Reactions to TEFRA

Commentators have routinely criticized the TEFRA partnership audit procedures. For example, as stated earlier, one commentator has suggested that more than 10,000 hours and $100 million in fees and other costs has been spent studying, auditing, and litigating the correct meaning of a single TEFRA provision -- section 6229.[227] Other commentators have questioned whether anyone would want to accept the role of TMP.[228]

Another commentator has suggested that the TEFRA partnership audit rules, other than the consistency requirement, should be repealed.[229] In making his recommendation, the commentator argued that neither the practical problems that drove creation of the TEFRA audit rules nor the tax policy rationales used to justify them retain strength today.[230] Instead, the author continues, improvements in substantive law applicable to partnerships and in technology available to the Service for the use in auditing large partnerships have significantly reduced the benefits derived from them.[231] As part of his argument related to changing circumstances, the commentator argues that the exclusion of ELPs and certain publicly traded partnerships from the TEFRA audit regime (noting that

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[226] *See* GAO Final Report at 26 (showing a timeline and suggesting that, on average, the Service has approximately 18 months to complete the audit of a large partnership).
[227] *See supra* note 143 and surrounding text.
[228] Harve M. Lewis & Norlyn D. Miller, Jr., Do You Really Want to Be the Tax Matters Partner?, Journal of Passthrough Entities, November-December 2011, at p. 17.
[229] PRESCOTT at 505.
[230] *Id.*
[231] *Id.*

the publicly-traded partnership regime was enacted after TEFRA[232]) served to effectively limit the scope and benefits of the TEFRA partnership audit rules.[233] The commentator also suggested that the Service's widespread use of technological advances has eliminated much of the benefits of the TEFRA partnership audit rules.[234] Finally, the commentator argues, changes to the Code, including the enactment of the passive loss limitation rules, have severely limited the syndication of tax shelters of the type being marketed at the time the TEFRA audit rules were enacted.

VII. Recommendations for a Path Forward

A. Can TEFRA be Saved?

The one conclusion that can be reached based on the discussion above is that something must change. The current TEFRA partnership audit rules are ineffective for the purposes for which they were enacted. Large partnerships are not being audited. Service personnel are not trained or supported in auditing large partnerships. A massive amount of litigation has arisen under TEFRA, and continues today. A threshold question, then, is whether it is possible to amend the TEFRA partnership audit rules to make them more efficient and to better achieve their stated purposes or whether the rules should be largely repealed.[235]

Regarding the call to largely repeal TEFRA, the GAO Final Report would refute many of the factual assumptions underpinning the arguments made to justify that the TEFRA audit rules are no longer needed. Particularly, the GAO Final Report indicates that the ELP

[232] *Id.* at 560.
[233] *Id.* at 559.
[234] *Id.* at 561-564.
[235] *See supra* notes 226-231 and surrounding text.

partnership audit regime is not widely elected,[236] that the numbers of large partnerships has grown dramatically since 2002,[237] and the Service continues to manually link partnership returns (Forms 1065), Schedule K-1s, and partner returns (Forms 1040, 1120, 1120-S, 1065, 1041, etc.).[238] Moreover, although very different from the syndicated tax shelter partnerships being syndicated prior to the enactment of TEFRA, the GAO Final Report discloses that, as of the 2011 tax year, there were more than 10,000 large partnerships (defined to be partnerships with at least 100 partners and at least $100 million in assets) and those partnerships held trillions of dollars in assets.[239] The GAO further notes that large partnerships have become increasingly complicated – many with multiple tiers of ownership.[240] The recent explosion in growth of large partnerships with complicated tiered structures harkens back to the situation Treasury faced in 1978 when TEFRA was first enacted.[241] Thus, despite advances in technology, subsequent legislative amendments (primarily passage of the passive activity loss rules), and the slowdown in syndication of the individual tax shelters of the 1970's and 1980's, large partnerships continue to grow in numbers, size and complexity for entirely different reasons than they

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[236] GAO FINAL REPORT at 31 (stating that few large partnerships elect to become ELPs) and at n.39 (noting that only 15 ELPs had 100 or more direct partners and $100 million or more in assets in tax year 2011).
[237] *Id.* at 1.
[238] *Id.* at 29 (noting that the campus information system does not have the capability to automate the process).
[239] *Id.* (noting that the number of such partnerships had more than tripled from 2002 to 2011). Perhaps one reason for the dramatic growth in the number of large partnerships is a liberalization of the exceptions to publicly traded partnership treatment. *See, e.g.*,
[240] GAO FINAL REPORT at 15-19 and 17, Figure 7 (noting that while the partnership structure in Figure 7 is complex, it has only 50 partners and 10 tiers and suggesting that larger partnership structures could be much more complex).
[241] 1978 Tax Program at 121-129 (including diagrams of tiered partnership structures that are much simpler structures than the structure shown in Figure 7 of the GAO Final Report).

did during the 1970's and 1980's.[242] A unified partnership audit regime can serve a useful purpose so long as large partnerships with complicated structures and numerous owners, including pass-through entity owners, continue to exist. The current TEFRA partnership audit regime has failed, but if the TEFRA partnership audit rules are substantially overhauled, including making the ELP regime (or something similar thereto) mandatory, then I believe that an overhauled TEFRA partnership audit regime can help increase not only the audit rates of large partnerships but also the change rates of the returns audited.[243]

Before I make recommendations for changes to the TEFRA partnership audit rules, however, I will first make recommendations that should be implemented irrespective of whether the TEFRA partnership audit rules are modified. The changes in this Part of the Article should apply to all TEFRA and non-TEFRA partnership audits except for audits falling under the ELP regime. The changes in this Part will decrease the Service's burden regarding all partnership audits, including TEFRA partnership audits.

B. Partnership Audits in General

As was discussed above, the GAO Final Report makes clear that large partnership audit rates and change rates are far lower for large partnerships than for C corporations of a similar size. Based on anecdotal evidence, audit and change rates of all partnerships – not

[242] *See supra* notes 5-7 and surrounding text.

[243] For purposes of this Part of the Article, change rate with respect to a partnership audit refers not only to an adjustment to overall partnership taxable income, but also to an adjustment to the allocation(s) of partnership items of income, gain, loss, and deduction between or among the partners. Thus, a no-change partnership audit is one in which there is no change to either (1) overall partnership taxable income or (2) the allocation of that taxable income between or among the partners.

only large partnerships – are low. [I am awaiting approval to send out a survey to select partnership tax professionals. I will augment this section with the survey results.]

1. Re-Allocation of Service Resources from Subchapter C to Subchapter K

The GAO Final Report shows that both the number of partnership returns and the aggregate amount of income reported on those returns has been growing since 2002 and the number of C corporation returns and the aggregate amount of income reported on those returns has been declining since 2002. Other statistics indicate this trend has been occurring over a much longer period of time.[244] As of 1990, business returns filed with the Service broke down as follows: (1) eight percent S corporations; (2) eight percent partnerships (including LLCs and LLPs taxed as partnerships); (3) 74 percent sole proprietorship; and (4) 11 percent C corporations (excluding 1120-RIC and 1120-REIT).[245] By 2008, the breakdown of business returns filed was as follows: (1) 13 percent S corporations; (2) 10 percent partnerships; (3) 72 percent sole proprietorships; and (4) six percent C corporations.[246] The data on the amount of net income on C corporation and partnership returns is even more telling. As of 1990, the percentage of total net income

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[244] *See* THE WHITE HOUSE AND THE U.S. DEPARTMENT OF TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM 8, Table 4 (February 2012) (showing the shares of total business returns filed, receipts collected, and net income for S corporations, partnerships, sole proprietorships, and C corporations for 1980, 1990, 2000, and 2008) [hereinafter 2014 PRESIDENT'S FRAMEWORK]. The data used to formulate Table 4 can be found at www.irs.gov/taxstats. *Id.* The 2014 President's Framework also displays data for tax receipts by entity type. I am not sure what receipts are being collected from S corporations and partnerships since neither is a tax paying entity. (Perhaps the receipts are from employment tax, the BIG tax on S corporations or excise taxes.) The receipts data is excluded here because it is not relevant because neither partnerships not S corporations generally pay income taxes. However, all income reported on a partnership or an S corporation return will be taxable to some direct or indirect owner who does pay tax (whether that owner is an individual, a C corporation, a complex trust, or an estate).
[245] *Id.*
[246] *Id.*

reported to the Service broke down as follows: (1) eight percent S corporations; (2) eight percent partnerships; (3) 74 percent sole proprietorships; and (4) 57 percent C corporations.[247] By 2008, the breakdown had shifted dramatically as follows: (1) 22 percent S corporations; (2) 32 percent partnerships; (3) 19 percent sole proprietorships; and (4) 27 percent C corporations.[248] Thus, as of 2008, nearly 1/3 of total net income reported to the Service on all returns was reported on a partnership return and, very importantly, much more net income was reported on partnership returns than on C corporation returns. Moreover, although not clear from the statistics, the amount of net income reported on C corporation returns likely double counts partnership income flowing to C corporations from partnerships in which the C corporations are partners. If the amount of net income reported on K-1 delivered to C corporations were removed from the C corporation business income number, then partnerships would likely account for an even larger share of the total net income reported to the Service on business returns.

Despite the dramatic shift from C corporations to S corporations and partnerships beginning in 1980 and continuing today and the explosion in the number of, and the number of partners in, large partnerships, the Service apparently has not re-aligned its resources to match the realities of the business community. For example, the Passthroughs and Special Industries division of the Internal Revenue Service ("IRS"[249]) Office of Chief Counsel in Washington, D.C. (the Service office charged with administering subchapter K of the Code within the Office of Chief Counsel) recently had to eliminate one of its seven

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[247] *Id.*
[248] *Id.*
[249] Throughout the reminder of this Article, the terms Service and IRS shall be used interchangeably.

branches altogether because of a lack of resources.[250] Moreover, as of May 2014, the IRS Office of Chief Counsel (Corporate) "has 6 branches and some 45 attorneys" and that division is devoted solely to C corporation issues.[251] Unlike the Corporate division of Chief Counsel which focuses solely on subchapter C of the Code (and a few directly related areas), the Passthroughs and Special Industries division of the Office of Chief Counsel (the branch charged with handling partnership issues) handles tax matters involving: (1) the income taxation of S corporations, partnerships, estates, trusts; (2) estate, gift, and excise taxes; (3) oil, gas, and other natural resources; (4) depletion; (5) general business tax credits; (6) research and experimental expenditures; (7) cooperatives and homeowners associations, (8) low-income housing credit, and (8) domestic production deductions.[252] Yet, as of May 2014, the Corporate division within the Office of Chief Counsel had "some 45 attorneys" whereas, despite its broader jurisdiction, the Passthroughs and Special Industries division within the Office of Chief Counsel had a total of 70 attorneys and that only 30 of those 70 work on passthrough issues.[253] Moreover, of those 30 attorneys working on passthrough issues, they have to cover subchapters K, S, and J of the Code.[254] Thus, despite that fact that

[250] Amy S. Elliott, Staff Losses Lead Chief Counsel to Shutter a Passthroughs Branch, Tax Notes Today, May 19, 2014, 2014 TNT 96-3 [hereinafter Staff Losses].
[251] *Id. See also* Internal Revenue Manual, Part 1. Organization, Finance, and Management, Chapter 1. Organization and Staffing, Section 6. Chief Counsel, Section 1.1.6.6 Associate Chief Counsel (Corporate) (listing the following areas of focus for the office: corporate organizations, reorganizations, liquidations, spin offs, transfers to controlled corporations, distributions to shareholders, debt vs. equity determinations, bankruptcies, and consolidated return issues affecting affiliated groups of corporations. Importantly, six of the nine areas are subsets of subchapter C of the Code and the other three are integrally related to subchapter C and continually surface in connection with C corporations).
[252] Internal Revenue Manual, Part 1. Organization, Finance, and Management, Chapter 1. Organization and Staffing, Section 6. Chief Counsel, Section 1.1.6.12 Association Chief Counsel (Passthroughs and Special Industries).
[253] *See* Staff Losses, *supra* note 251.
[254] *Id.*

more business income is now reported on partnership returns than on C corporation returns (at least 5 percentage points more before considering any partnership income that was double counted) and that more partnership returns are filed than C corporation returns, the Service has not reallocated its resources to match the realities of the business community. Moreover, partnerships, being aggregates of their partners for tax paying purposes, are much more difficult to audit than C corporations, which pay taxes at the corporate (entity) level. Any adjustment made to a partnership tax return must be passed through to each partner and a corresponding adjustment made to the partner's individual return.

I began practicing in 1990 and I do not recall any significant change in the jurisdiction of the various divisions in the Office of Chief Counsel. Clearly, the jurisdiction of the Corporate division of the Office of Chief Counsel has not expanded – it would be difficult for its jurisdiction to be more limited. The various jurisdictions within the Office of Chief Counsel were likely set prior to the explosion in the use of partnerships following the repeal of General Utilities, the advent of limited liability companies, and the promulgation of the check-the-box regulations.[255] The government seems to remain stuck in the 1954 mindset where "the partnership form of organization [was] much more commonly employed by small businesses and in farming operations than the corporate form."[256] Times have changed -- that is simply no longer the case and the Service's own statistics prove that it is no longer the case.

One can only assume the misallocation of resources evidenced in the Washington, D.C. IRS Office of Chief Counsel is consistent all throughout the Service.

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[255] *See supra* notes 5-7 and surrounding text.
[256] H.R. Rep. No. 83-1337, 2d Sess. 65.

The limited resources allocated to partnerships in the IRS Office of Chief Counsel in Washington, D.C. is also evidenced by the lack of guidance on the most important, fundamental, and far-reaching unresolved issues in the partnership community. For example, nearly all partnership agreements drafted today contain targeted (versus safe harbor) allocations.[257] Targeted allocations have existed since the early 1990's and have been the predominant allocation method for about two decades. Yet, the Service has never issued any guidance regarding targeted allocations despite the fact that targeted allocations gained widespread use two decades ago and commentators have been writing about them for years.[258] The Service has recently announced its intent to study targeted allocations with a view toward releasing guidance.[259] As another example, private equity fund present a host of unique issues that commentators written about for decades including

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[257] NOEL P. BROCK, TARGETED PARTNERSHIP ALLOCATIONS: PART I, 44 THE TAX ADV. 374 (2013) (noting that "[t]oday, nearly all partnership allocations contain targeted allocations, and very few contain safe harbor allocations"). For a discussion of targeted versus safe harbor allocations, *see id.* and NOEL P. BROCK, TARGETED PARTNERSHIP ALLOCATIONS: PART II, 44 THE TAX ADVISER 464 (2013). Safe harbor allocations are generally used only if the drafter of the partnership agreement wants to ensure compliance with some allocation safe harbor elsewhere in the Code that applies only if the allocations in the partnership agreement are safe harbor compliant. *See*, *e.g.*, section 514(c)(9)(E) (fractions rule) and Treas. Reg. § 1.704-2(e) (nonrecourse debt allocation safe harbor).
[258] For some more recent articles addressing targeted allocations *see*, *e.g.*, *id.*; Terrence F. Cuff, Several Thoughts on Drafting Target Allocation Provisions, in Practising Law Institute, Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances, Ch. 66-1 (2011) (the original article was published several years prior to the 2011 PLI publication); TERRENCE F. CUFF, TARGET ALLOCATIONS AND THE REDEMPTION OF A MEMBER, 37 J. REAL ESTATE TAX'N 60 (First Quarter 2010) (suggesting that accountants are struggling to understand targeted allocation provisions); WILLIAM G. CAVANAGH, TARGETED ALLOCATIONS HIT THE SPOT, 129 TAX NOTES 89 (Oct. 4, 2010); TODD D. GOLUB, HOW TO HIT YOUR MARK USING TARGET ALLOCATIONS IN A REAL ESTATE PARTNERSHIP, 50 TAX MGT. MEM. 403 (Sept. 28, 2009); New York State Bar Association, Tax Section, Comment Letter to Treasury, Partnership Target Allocations, reprinted in 2010 TNT 185-18 (Sept. 23, 2010).
[259] Amy S. Elliott, IRS to Lay Groundwork for Guidance on Targeted Allocations, Tax Notes Today, May 22, 2014, 2014 TNT 99-2.

management fee waivers,[260] clawback provisions,[261] and so-called stuffing allocations.[262] Finally, commentators first raised over ten years ago the issue of purported preferred returns that cumulate even during years when the partnership has no actual income and questioned whether such purported preferred returns should be characterized as income in the year they accrue as an accession to wealth.[263] We have no guidance on any of these important, fundamental, and far-reaching issues.

In order to adequately audit partnerships, including large partnerships, the IRS must reallocate its scarce resources away from subchapter C and to subchapter K to match the monumental shift in choice of business entity by the business community over the last three decades.[264] The reallocation should be based, at least in large part, on the numbers of business returns filed and the dollar amounts of income reported on those returns.

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260 James H. Lokey, Jr. & Donald E. Rocap, Selected Tax Issues in Structuring Private Equity Funds, 62nd N.Y.U. Institute on Fed. Tax'n, Chapter 11 (2004) (discussing management fee waivers, clawback provisions and several other issues germane to the private equity fund industry).

261 *Id.*

262 Brian E. Ladin, James M. Lowy & William S. Woods II, Hedge Fund Stuffing Allocations: A Path Through the Maze, Tax Notes Today, November 25, 2008, 2008 TNT 228-34; Letter from Terrence F. Cuff to Michael Mundaca, Douglas H. Shulman & William J. Wilkins, March 30 2011, reprinted in Tax Notes Today, March 30, 2011, 2011 TNT 66-24 (among other things, Mr. Cuff scolded the IRS for its focus on examining the travel and entertainment expenses of large securities partnerships when it should be examining the aggressive tax positions on those same returns and adding that lax auditing practices make the IRS complicit in the tax abuse).

263 LEWIS R. STEINBERG, FUN AND GAMES WITH GUARANTEED PAYMENTS, 57 TAX LAW. 533 (Winter 2004). Even if an accrual basis partnership does not pay the purported guaranteed payment or liquidate in the year the purported guaranteed payment accrues, there is an accession to wealth since the purported preferred return accrues annually and is cumulative. Thus, the holder of the preferred return enjoys an immediate economic entitlement to receive the return when it accrues even if it is paid at a later date. *See* Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) (holding that gross income includes "undeniable accessions to wealth").

264 As part of the re-allocation process, the IRS should examine all of its various divisions and their jurisdictions to ensure that it is allocating resources to match the realities of today.

Moreover, this reallocation should be done immediately. The government should allocate sufficient resources to the subchapter K division of the IRS to allow it to push partnership audit adjustments through to the individual partner's returns.[265] The IRS should monitor the numbers of returns being filed and the dollar amount of income reported on those returns going forward and reallocate resources whenever necessary to match changes in the business community. Also, given how slow the Service has been to adapt to changes in the business community and the constant turnover at the IRS, Congress should enact legislation providing parameters governing the reallocation of resources at the IRS among its divisions (two key parameters should be the number of business returns filed and income reported on those business returns by entity type). Further, Congress should provide for GAO oversight of such resource reallocation on an ongoing basis, to ensure the IRS is properly allocating its scarce resources based on then-current business actualities in the future.

As part of this re-allocation of resources, I also recommend that the partnership function within the Office of Chief Counsel be segregated into its own separate division so that it can adequately devote the time and effort necessary to keep up with the shift that has occurred, and that is ongoing, in the business community by timely responding to requests for guidance and adequately auditing partnerships. Finally, I recommend that the IRS update annually the statistics on its web site disclosing to Congress and the Service's other stakeholders the number of business returns being filed and the amount of business

[265] Because partnerships do not pay tax but, instead, their partners pay tax on their allocable share of partnership income, the Service must pass along any partnership level adjustment to each partner and make sure the partner's individual return is corrected for the adjustment. This problem becomes exponentially more difficult in a tiered partnership structure.

income being reported by each category of entity. It will be impossible for the Service to increase the audit rate of partnerships, or to increase the change rate for those partnership returns it does audit, unless and until there is a shift in resources throughout the IRS to re-align IRS resources with the realities of the business community. Also, if possible, C corporation income should not include any income flowing into the C corporation from a partnership on Schedule K-1. Regularly publishing this data will allow Congress and other stakeholders to monitor and make ongoing recommendations about the allocation of scarce IRS resources.

2. Specialization and Training of Service Personnel Auditing Partnerships

Because partnership taxation affords taxpayers broad flexibility[266] and because a partnership is sometimes viewed as an entity separate from its owners but is at other times viewed as an aggregate of its owners, partnership taxation is recognized as one of the most difficult areas of taxation.[267] Not surprisingly, the GAO Final Report confirmed what anecdotal evidence had suggested for years – that IRS personnel do not have adequate

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[266] Taxpayers are free to form a partnership to accommodate virtually any kind of economic deal they can dream up subject only to the rule that allocations must follow the partner's interest in the partnership. Section 704(b).

[267] *See*, *e.g.*, Denis Clifford & Ralph Warner, Form a Partnership: The Complete Legal Guide 130 (9th ed. 2012) (recognizing that partnership taxation at its more complicated levels "is generally recognized as one of the most difficult areas of the Internal Revenue Code"); LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS 1 (4th ed. 2011 West Publishing Co.) ("Subchapter K has a well-earned reputation as one of the most complex areas of the tax law . . . ."); KAREN C. BURKE, FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS IN A NUTSHELL III (Preface) (4th ed. 2013 Thomson Reuters) (stating that the mechanical rules of partnership taxation "have become increasingly complex in recent years" and that this complexity is "sometimes daunting"); Foxman v. Commissioner, 41 T.C. 535, 551 n.9 (1964) ("The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field.").

training or substantive technical knowledge of partnership tax issues.[268] In particular, focus group participants stated that they "had limited knowledge of the technical tax issues for partnerships."[269]

To overcome the challenges imposed by mastering such a complicated area of the tax law, I recommend that the IRS form teams of auditors who specialize in audits of partnerships and that those teams operate throughout the United States. The largest accounting firms already have teams of specialists who handle partnership tax issues. It is unrealistic to expect an auditor who "may only work on a partnership audit once every few years" to understand subchapter K well enough to satisfactorily conduct an audit of all but the simplest of partnerships. Moreover, those IRS personnel conducting partnership audits should be required to complete in-depth training on partnership taxation (certainly more in-depth than is currently provided or required).

3. Partner-Partnership Consistency Rule Should Apply to All Partnerships

Currently, only partners in partnerships subject to the TEFRA partnership audit rules are required to file consistently with the partnership unless the partner discloses the inconsistency in the partner's individual return. The consistency rule should be expanded to apply to all partnerships.

4. Upgrade the Service's tracking of Partnership Audits

I concur with the GAO recommendations related to tracking partnership audits contained in the GAO Final Report, but I would recommend to extend those recommendations to all partnerships – not only large partnerships. I also would recommend additional tracking not contained in the GAO Final Report.

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[268] GAO FINAL REPORT at 32.
[269] *Id.*

a. Concur with GAO Recommendations – But Extend to All Partnerships

Consistent with the GAO recommendations, the Service should segregate its partnership audits by activity code for the partnership's asset size (as it currently does for corporate audits),[270] track the number of no-change audits,[271] track enforcement revenue and analyze audit results by activity codes to identify opportunities and better plan partnership audits,[272] and either exclude so-called "campus function audits" from the data or separately track field audits and campus function audits.[273]

b. Additional Recommendations

In addition to the GAO recommendations regarding tracking audits, I recommend that the Service track not only changes to overall taxable income but also changes to partnership allocations between or among the partners. Other than accurately computing taxable income and making tax elections, the most important function occurring on a partnership tax return is the allocation of income between or among the partners. The Service should monitor and track whether its audits are adequately auditing these allocations. [I am awaiting approval to send out a survey to select partnership tax professionals. I will augment this section with the survey results.]

Additionally, the GAO reported that the Service currently maintains important information by hand.[274] The Service should adopt digital filing and tracking of all partnership returns, including Schedules K-1 for each partner in a partnership.[275]

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[270] GAO FINAL REPORT at 38-39.
[271] *Id.* at 17.
[272] GAO FINAL REPORT at 39.
[273] *Id.*
[274] GAO FINAL REPORT at 29 (noting that the campus information system does not have the capability to automate the process).

Finally, consistent with these recommendations, Congress should appropriate the necessary funds to allow the Service to implement these changes.

5. Require Certain Small Entities to Operate as S Corporations

Another way Congress can help the Service in its effort to increase compliance with subchapter K and make partnership audits more effective and efficient is to take actions to reduce the number of partnerships in existence. As recently as 2013, a member of Congress questioned whether we could eliminate two flow-through regimes in favor of a single flow-through regime.[276] While I believe the existing two flow regimes serve very different users who often have very different objectives, I also believe many small partnerships with straight up allocations should be operating in the S corporation form instead. Taxpayers and practitioners oftentimes do not adequately consider whether to form a partnership or as an S corporation. Too often, advisers put taxpayers into partnerships when their economic deal could work fine in an S corporation vehicle.

There are, however, key differences between the tax treatment of S corporations and partnerships. For example, unlike partnerships, certain S corporations are generally prohibited from generating more than a specified amount of revenue from passive investment income (those S corporations with accumulated C corporation earnings and profits),[277] are prohibited from having more than a single class of stock,[278] and must not have more than 100 shareholders, each of which is an individual, an estate, or certain trust

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[275] *See* 1997 BLUEBOOK at 354 (recognizing that the Schedule K-1 contains space for more than 40 items).
[276] 2013 Camp Proposal.
[277] Section 1362(d)(3).
[278] Section 1366(b)(1)(D).

sand none of which is a nonresident alien.[279] Also, S corporation shareholders cannot include in the shareholder's outside basis in S corporation stock any entity level debt[280] or the amount of any loan made directly by the shareholder to the S corporation.[281] Finally, S corporation shareholders are treated different from partners with regard to self-employment taxes.[282]

Congress should conform certain of the differences between the S corporation rules and the partnership rules, including inclusion of debt in the owner's basis and computation of self-employment taxes. Thereafter, Congress should mandate that taxpayers forming a new entity or converting a C corporation to a pass-through entity must form an S corporation if the entity (upon formation) will have (1) pro rata allocations (and no preferred return, options, etc.), (2) 100 or fewer shareholders, (3) no S corporation disqualified owners, and (4) if subchapter C earnings and profits are present, the entity has a sufficiently small amount of passive income to allow the entity to form as an S corporation. However, Congress should also modify current law such that if an S corporation ever adopts non-pro rata allocations, a preferred return, adds the 101st owner, has a disqualified owner, or has sufficient passive income to terminate the S election, then the S corporation would be allowed a tax-free conversion of the entity to partnership status (*i.e.*, eliminate the 311 gain in such circumstances).

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279 Section 1361(b).
280 Section 1367.
281 Perry v. Commissioner, 54 T.C. 1293, 1296 (1970); Rev. Rul. 81-187, 1981-29 C.B. 167.
282 *See*, *e.g.*, Prop. Treas. REG-209824-96 (proposing a unified self-employment tax regime for all self-employed individuals). Several politicians opposed the proposed regulations (likely because they were taking advantage of the preferential treatment afforded S corporation shareholders regarding self-employment tax). *See* Gingrich Slams Limited Partnership Regs, Tax Notes Today, April 3, 1997 (providing a transcript of a telephone call from Newt Gingrich to Rush Limbaugh).

Such changes should drastically reduce the number of partnerships in existence, thereby lightening the Service's burden with respect to partnership compliance.

6. Failure to File Penalty

For all partnerships, Congress should increase the failure to file penalty for a partnership return to something more meaningful and make the partnership and each individual partner jointly and severally liable for payment of the penalty.[283]

7. Tiered Partnership Issues

Many of the current problems with tiered partnerships will disappear if my suggestion (below) to mandate the ELP regime is adopted. In addition, I recommend the following actions be taken to alleviate some of the issues the Service encounters when it audits partnerships with complicated multi-tier structures:

a. Require all partnerships with tiered structures that are under common control to electronically disclose ownership structure (organization chart) as a part of filing of the partnership return.
b. Require all partnerships to electronically disclose each (lower tier) partnership in which it owns an interest.
c. Require each pass-through partner that acquires an interest in a partnership to electronically disclose to the (lower-tier) partnership the identity of each owner of an interest in the pass-through partner.
d. The Service should use electronic information from electronically filed partnership returns (including electronic K-1's and information obtained in items a-c above) to build and maintain a database of tiered partnership structures.

C. TEFRA: Substantially Overhaul or Repeal and Tax Large Partnerships as Corporations

The recommendations outlined above should be adopted irrespective of whether the TEFRA audit rules are amended. Regarding TEFRA, despite calls to largely repeal

[283] Under section 6698(b)(1), the current penalty is $195 per partner per year, but the penalty is assessed solely against the partnership. Section 6698(c).

TEFRA, I believe TEFRA can continue to serve several useful purposes and satisfy the reasons why it was enacted, but only if it is substantially overhauled.

a. Make the ELP Partnership Audit Regime Mandatory

Consistent with the recommendations of the 2014 President's Framework and the GAO Final Report, Congress should amend TEFRA to make the ELP partnership audit regime mandatory for all partnerships with at least 100 direct or indirect partners at any time during a tax year. Moreover, for ELPs, the Service should be allowed to collect any tax due at the partnership level in all cases. Mandating the ELP partnership audit regime that allows the IRS to collect tax at the partnership level should dramatically reduce the Service's burden in auditing large partnerships.

b. Other Changes for TEFRA Partnership Audits

Under existing rules, the TEFRA partnership audit rules apply to any partnership with greater than 10 partners (and to some partnerships with fewer than 10 partners). Thus, there are many TEFRA partnerships with fewer than 100 direct partners or indirect partners. All of the following recommendations apply to those TEFRA partnerships that are not subject to the mandatory ELP audit regime. Moreover, where indicated, the following recommendations should also apply to partnerships subject to the mandatory ELP TEFRA partnership audit regime.

i. Congruent of Statutes of Limitation

For both mandatory ELP TEFRA partnerships and non-mandatory ELP TEFRA partnerships, Congress should amend sections 6229 and section 6501, and any related provisions of the Code, to make the two statutes of limitations congruent. If not, then the section 6501 period of limitations should not begin until the later of the dates on which the partnership and individual partner return is filed.[284] Once the two separate statutes of limitation are made congruent, then the concepts of partnership item, affected item, and non-partnership item should no longer be necessary.[285]

ii. TMP Designation and Update

Consistent with the GAO Final Report, Congress should require that all TEFRA partnerships (mandatory ELP TEFRA partnerships and non-mandatory ELP TEFRA partnerships) designate a TMP on its partnership tax return and provided updated TMP information to the Service once an audit of the partnership is initiated. Additionally, Congress should impose penalties on the partnership for failure to designate a TMP on the partnership return and for failing to provide updated information to the Service once the audit of the partnership is initiated. Finally, the statute of limitations should automatically extended if the partnership fails to designate a TMP on its tax return or fails to provide updated TMP information to the Service once an audit is initiated until such time as the TMP has been designated or the updated TMP information has been provided.

iii. Streamline the Notice Process

Regarding mandatory notices by the Service to partners, Congress should clarify that the Service has no duty to look beyond the face of the partnership return and other information supplied by the TMP when providing notice to partners at the beginning of a TEFRA partnership audit and when sending out the NPAA at the end of the TEFRA partnership audit. Moreover, to provide some level of protection to other partners, the

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[284] *See* Jones at 683.
[285] *See* 2014 CAMP PROPOSAL at 255 (proposing to eliminate the distinctions among partnership items, non-partnership items, and affective items).

TMP should be subject to penalties for failure to fulfill its duties, including its obligation to share IRS notices with other partners.

iv. Mandate that a Single Person Serve as the Main Point of Contact for Each of the Partnership and Each of its Partners

Based on anecdotal evidence, partnerships often have to deal with several different IRS personnel in different offices to finally close a TEFRA partnership audit. I recommend that a single person at the Service serve as the contact person between the TEFRA partnership and the Service and that this single point of contact have authority to bind the Service with respect to the TEFRA partnership return and with respect to each individual partner's return regardless of the location of the partnership's principal place of business and regardless of where each individual partner resides. [I am awaiting approval to send out a survey to select partnership tax professionals. I will augment this section with the survey results.]

v. Allow Partnership-Level Payment of Tax Due Unless Partnership Allocations are Adjusted

For non-mandatory ELP TEFRA partnership audits in which the Service does not propose to change the allocation of income, gain, loss, deduction or credit between or among the partners, the non-mandatory ELP TEFRA partnership should be allowed to pay the tax related to the adjustment at the entity level and then to allocate that payment between or among its partners (it would simply be treated as a cash distribution by the partnership to each partner). Only where the Service changes allocations of income, gain, loss, deduction or credit between or among the partners should the Service be required to push the adjustment through the individual partners' returns.

vi. GAO to Monitor the New TEFRA System for Ten Years

To ensure that the new TEFRA partnership audit rules are achieving their objectives, Congress should ask the GAO to observe (1) audit rates and (2) change rates for all partnership audits segregated based on size of the partnership (number of partners) and amount of assets. The GAO should monitor both changes to taxable income as well as changes to partnership allocations.

Additionally, Congress should mandate that the GAO develop a survey to be completed by the TMP of each TEFRA partnership audited by the Service and returned to the GAO. Some questions the survey should ask would include:

> a. Were you able to deal with a single Service representative throughout the audit process?
> b. Did the Service scrutinize the correctness of the partnership allocations between or among the Partners?
> c. Did the Service perform more than a cursory review of the partnership's allocations between or among the partners?

The GAO should publish annually the results of its oversight and recommend any changes necessary.

D. Repeal TEFRA and Tax Large Partnerships as Corporations

Consistent with the recommendation of the U.S. Treasury so many years ago,[286] if the changes outlined above are not made or if they are made but ultimately prove ineffective, then the TEFRA partnership audit regime should be repealed and partnerships with greater than 100 direct or indirect partners should be treated as C corporations for tax purposes. However, even if the TEFRA partnership audit regime is repealed, Congress should retain the consistency requirement (requiring partners to report items consistent

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[286] 1978 TAX PROGRAM at 69 (proposing to classify as limited partnerships with more than 15 partners, the S corporation shareholder limit at the time, as corporations for tax purposes).

with the partnership or give the Service notice of inconsistent treatment) for all partnerships.[287]

E. Conclusion

The TEFRA audit rules have failed their intended purposes. Despite that failure, a unified partnership audit regime is needed. The repeal of *General Utilities*, the passage of limited liability company statutes by states, and the promulgation of the check-the-box regulations have caused an explosion in the use of partnerships by businesses.[288] Moreover, the number of large partnerships has grown exponentially over the past few decades. These conditions are nearly identical to the conditions that existed when TEFRA was enacted in 1982.[289] This Article argues that it would be wrong to repeal TEFRA when the very reasons TEFRA was enacted continue to pervade the business community. Instead, Congress should substantially overhaul the TEFRA partnership audit regime to ensure it satisfies the reasons why it was enacted. Such changes are not that monumental, but should dramatically improve the effectiveness and efficiency of TEFRA partnership audits.

If, however, Congress decides not to substantially overhaul TEFRA, then the TEFRA partnership audit regime, other than the consistency requirement, should be repealed and large partnerships should be treated as corporations for tax purposes as proposed by Treasury in 1978.

[287] *Supra* note 194.
[288] *Supra* notes 5-7 and surrounding text.
[289] Although, the explosion in the use of partnerships prior to the enactment of TEFRA was the result of individual tax shelters. Today the explosion has occurred for different reasons. *See supra id*.