Judicial Review of Partnership Adjustment (Section 6234)

Prepared by:
Charles D. Pulman and Mary E. Wood
Meadows, Collier, Reed, Cousins, Crouch & Ungerman, L.L.P.

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Published on www.lorman.com - August 2020

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JUDICIAL REVIEW OF PARTNERSHIP ADJUSTMENT (Section 6234)

A. Lawsuit to Challenge FPA

Within 90 days after the date on which a notice of a FPA is mailed, the partnership may file a petition for a readjustment of any partnership adjustment reflected in the FPA, without regard to whether a Push-Out Election has been made with either (1) the United States Tax Court, (2) the district court of the United States for the district in which the partnership's principal place of business is located or (3) the United States Court of Federal Claims. Under Section 6241(5), a principal place of business located outside the United States is treated as located in the District of Columbia. Section 6234(a); Reg. § 301.6234-1(a).

B. District Court and Court of Federal Claims

A petition for readjustment may be filed in a district court of the United States or the Court of Federal Claims only if the partnership filing the petition deposits with the IRS, on or before the date the petition is filed, the Imputed Underpayment Amount (as of the date of the filing of the petition) if the Partnership Adjustment was made as provided by the FPA. If there is more than one Imputed Underpayment reflected in the FPA, the partnership must deposit the amount of each Imputed Underpayment to which the petition

for readjustment relates and the amount of any penalties, additions to tax, and additional amounts with respect to each such imputed underpayment. Reg. § 301.6234-1(b).

Any amount deposited with the court will not be treated as a payment of tax except that the deposit will be treated as a payment of tax to stop the accrual of interest. Reg. § 301.6234-1(c). The IRS is to issue guidance as to how a refund of an overpayment of a deposit is obtained by the partnership. *Id* at (c).

No deposit is required for a petition filed in Tax Court.

Observation: This deposit requirement for filing a lawsuit in either federal district court or the Court of Federal Claims raises several issues where a partnership wishes to make a Push Out Election to have its partners pay the tax attributable to Partnership Adjustments rather than having the partnership pay the Imputed Underpayment Amount. In this situation, the partnership and the Reviewed Year partners will need to make arrangement as to the source of funds for the deposit and a reconsideration after the court case is final.

C. Interest

Under Section 6234(b)(2), any amount deposited under Section 6234 is not to be treated as a payment of tax for purposes of the Code, other than for purposes of Chapter 67 (Interest). Presumably, the deposit will earn interest if it is ultimately refunded to the partnership.

D. Scope of Judicial Review

A court with which a petition is filed has jurisdiction to determine all items of income, gain, loss, deduction, or credit of the partnership for the partnership taxable year to which the FPA. Section 6234(c).

E. Appeals

Any determination by the U.S. Tax Court, district court or Court of Federal Claims has the force and effect of a decision or final judgment from that court, as the case may be, and is reviewable as such. The date of any such determination is treated as the date of the court's order entering the decision. Section 6234(d).

F. Effect of Dismissal

If an action filed in any of the courts described above is dismissed, other than by reason of rescission under Section 6231(c), the dismissal is considered as a decision that the FPA is correct and an appropriate order will be entered in the records of the court. Section 6234(c); Reg. § 301.6234-1(d).

G. Tax Court Rules

The Tax Court has issued new interim and proposed Rules under new Title XXIV A addressing petitions filed under the Audit Regime. These Tax Court Rules specifically discuss the partnership representative requirement and how to handle inclusion of the Imputed Underpayment. In addition, these new Tax Court Rules include a provision giving the Tax Court the power to remove for cause a partnership representative and the appointment of a successor by the partnership.

STATUTE OF LIMITATIONS (SECTION 6235)

A. Statute of Limitations - Three Time Periods

Section 6235 and Reg. § 301.6235-1 provide that, except as otherwise provided, no adjustment may be made after the later of:

1. The date which is 3 years after the latest of (A) the date on which the partnership return for such taxable year (ie, Reviewed Year) was filed, (B) the return due date for the taxable year or (C) the date on which the partnership filed an AAR with respect to such year ("3-Year Rule"), or
2. In the case of any modification under Section 6225(c) of an Imputed Underpayment, the date that is 270 days (plus the number of days of any extension consented to by the IRS under Section 6225(c)(7)) after the date on which everything required to be submitted to the IRS (as defined in Reg. § 301.6235-1(b)(2)) pursuant to Section 6225(c) is submitted, or
3. In the case of a NOPPA, the date that is 330 days (plus the number of days of any extension consented to by the Secretary under Section 6225(c)(7)) after the date of such Notice.

A NOPPA is timely if it is mailed before the 3-Year Rule period expires. Section 6231(b)(1); Reg. § 301.6231-1(b)(1) . The FPA cannot be mailed earlier than 270 days after the date the NOPPA is mailed unless the partnership elects to waiver the 270 day period requirement. Section 6231(b)(2)(A); Reg. § 301.6231-1(b)(2).

B. Agreements to Extend

The statute of limitations may be extended by an agreement entered into by the IRS and the partnership before the expiration of such period. Reg. § 301.6235-1(d).

C. Exceptions

1. Fraudulent Return: No statute of limitations applies in the case of a false or fraudulent partnership return with intent to evade tax. Section 6235(c)(1).

2. Substantial Omission: The 3-year statute of limitations is extended to 6 years if any partnership omits from gross income 25% or more of income described in Section 6501(e)(1)(A). Section 6235(c)(2).

3. No Return: If no return is filed for a taxable year, statute of limitations does not run and the adjustment may be made at any time. A "substitute return" executed by the IRS under Section 6020(b) on behalf of the partnership is not treated as a return of the partnership. Section 6235(c)(3).

D. Suspension of Statute of Limitations

1. FPA. If a FPA is mailed, the running of the statute of limitations, as modified by other provisions in Section 6235, is suspended for the period during which an action may be filed in court (and if a petition is filed, until the decision of the court becomes final), and for 1 year thereafter. Section 6235(d).

E. Bankruptcy Proceeding

1. General. If a partnership is a debtor in a Title 11 case, the statute of limitations is tolled for making a Partnership Adjustment, or assessment or

collection of any Imputed Underpayment until 60 days after the suspension ends for adjustments or assessments and 6 months after the suspension ends for collection. Reg. § 301.6241-2(a)(1).

2. Judicial Review. The statute of limitations is tolled regarding judicial review of Partnership Adjustments until 60 days after the termination of the period of time during which the partnership is prohibited from filing a petition under Section 6234. Reg. § 6241-2(a)(3).

3. Actions Not Prohibited. A Title 11 case does not suspend the following:

   a. Administrative Proceeding;
   b. Notice of a proceeding, including a NAP, NOPPA, FPA;
   c. Demand for tax returns;
   d. Assessment of any tax; and
   e. Issuance of notice and demand for payment of assessment.

Reg. § 301.6241-2(a)(4).

XI. OTHER SPECIAL PROVISIONS (Section 6241)

A. Partnership Payments Non-Deductible

No deduction is allowed for any payment required to be made by a partnership under the PAR. Section 6241(4). Reg. § 301.6241-4 states such payments are treated as an expenditure under Section 705(a)(2)(B) (expenditures not deductible and properly chargeable to capital account). Section 705(a)(2)(B) expenditures reduce the adjusted basis in the partnership interest of the partner. The Regulations do not address how to treat the underlying adjustments to income that resulted in the Imputed Underpayment and whether these adjustments should be taken into account under Section 705(a)(1)(B).

The Blue Book at page 79 states that the payment of tax made by the partnership reduces the adjusted basis in the assets of the partnership.

B. Partnership Ceases to Exist

1. General. If IRS determines that a partnership "ceases to exist" before any Partnership Adjustment "takes effect", the Partnership Adjustment is taken into account by the "former partners" and the partnership ceases to be liable for the Partnership Adjustment. This provision does not apply to a partnership that has made a valid Opt Out Election for the Reviewed Year. However, this provision applies to a partnership-partner and its former partners even if the partnership-partner made an opt-out election for itself under Section 6221(b). Reg. § 301.6241-3(a)(1), (2) and (3).

2. Partnership "Ceases to Exist"- Reg. § 301.6241-3(b).

   a. Determination. A determination of "ceases to exist" is made in the sole discretion of the IRS, but the IRS is not required to do so. If IRS makes that determination, the IRS is to notify the partnership and "former partners" in writing within 30 days of the determination.

   b. Definition. "Ceases to exist" means the partnership (i) terminates under Section 708(b)(1), *i.e.*, ceases to carry on business, or (ii) does not have the ability to pay, in full, any amount due by the partnership. The IRS has the discretion to determine whether the Partnership has the ability to pay (i.e., not collectible) based on

information the IRS has at the time. "Ceases to exist" does not arise solely because of (i) a valid Push Out Election under Section 6226 is in effect, (ii) the partnership received a Push Out statement and furnished the required statement to is partners or (iii) the Partnership has not paid any amount required to be paid.

c. Year Ceases to Exist. If termination under Section 708(b)(1), the applicable year is the last day of the partnership's final taxable year. If partnership does not have ability to pay, the applicable year is the date the IRS makes that determination.

d. Limitation. A determination of "ceases to exist" cannot be made after the expiration of the period of limitations on collection relating to the applicable adjustment period.

3. Definition of "Takes Effect". A Partnership Adjustment "takes effect" when all amounts due under PAR resulting from the Partnership Adjustment are fully paid by the partnership. Reg. § 301.6241-3(c)(1).

4. Former Partners. Generally, "former partners" means the partners during the Adjustment Year that corresponds to the Reviewed Year audited and the partners of a partnership-partner that has "ceased to exist." If there are no Adjustment Year partners, "former partners" means the partners of the partnership during the last taxable year for which a partnership return of the partnership was filed under Section 6031. Reg. § 301.6241-3(d).

5. Accounting for Adjustment. The Partnership Adjustment is treated as though the partnership made a Push Out Election to the "former partners" and the Partnership is required to notify both the former partners and the IRS in writing of the adjustments, which notification is to be made within 30 days after the IRS notified the partnership that the partnership has ceased to exist. Reg. § 301.6241-3(e). If the required statements are not timely delivered to the former partner and the IRS, the IRS will notify the former partners of the Partnership Adjustments based on information recently available to the IRS. Reg. § 301.6241-3(e)(3).

C. Entities Filing Partnership Returns

If a partnership return is filed by an entity for a taxable year, the entity is subject to PAR even if it is determined that the entity is not a partnership (or that there is no entity) for such year. PAR is applied to such entity for such year and its tax items and to persons holding an interest in such entity unless the Opt Out Election is made or the election under § 761(a) is made. Section 6241(8); Reg. § 301.6241-5

D. Information Returns

PAR also amend Section 6031(b) which requires partnerships to provide its partners with certain information as required under IRS Regulations (i.e., Schedule K-1s). PAR deletes the last sentence requiring such information to be provided by electing large partnerships by March 15th and instead adds a provision stating that except as provided in the procedures under Section 6225(c) (dealing with modifications to the Imputed Underpayment Amounts), with respect to Section 6226(c) (providing alternative

procedures to the Imputed Underpayment Amount payment requirement by a partnership), or as otherwise provided by the Secretary, information required to be furnished by the partnership under Section 6031(b) may not be amended after the due date of the partnership return.

Note: This provision effectively precludes a partnership from changing information provided in a K-1 after the due date of the partnership return. It is not clear how this prohibition against amendments correlates with a partnership's ability to file Administrative Adjustment Requests (i.e., amended partnership returns) with the IRS.

E. Appealing IRS Determinations under PAR

The Proposed Regulations do not address the right of the partnership to appeal IRS determinations under PAR, such as IRS decisions relating to Opt Out, partnership representative designation, Push Out Election, modification requests, partner-level defenses, partnership ceasing to exist, or adjusted items in the NOPPA.

F. Definitions

1. Indirect Partner. The term "indirect partner" means any person who has an interest in a partnership through their interest in one or more pass-through partners or through a disregarded entity. Reg. § 301.6241-1(a)(4).
2. Pass-Through Partner. The term "pass-through partner" means a pass-through entity, holding an interest in a partnership and is a partnership required to file a return under Section 6031(a); an S corporation, certain trusts, and a decedent's estate. A "pass-through entity" for these purposes

is not a disregarded entity or a trust wholly owned by only one person. Reg. § 301.6241-1(a)(5).

3. Partnership-partner. The term "partnership-partner" means a partnership that holds an interest in another partnership. Reg. § 301.6241-1(a)(7).

G. CFC and PFIC Shareholders

TTCA added new Section 6241(12) which deems certain shareholders of a foreign corporation as "partners" for purposes of the Audit Regime.

1. CFC. If a controlled foreign corporation is a partner in a partnership, each "United States shareholder" under Sections 951(b) or 953(c)(1) is treated as the partner of the partnership. Section 6241(12)(A).

2. PFIC. Each taxpayer that makes an election under Section 1295 with respect to a passive foreign investment company under Section 1297 is treated in the same manner as a United States shareholder. Section 6241(12)(B).

TAXATION WITHOUT REPRESENTATION?

A. Constitutional Concerns

1. Under PAR, partners of the partnership can be responsible for the tax arising out of the partnership audit notwithstanding their lack of notice and participation in the examination or judicial proceedings, ie – Push Out Election, partnership fails to pay or partnership "ceases to exist."

2. Two constitutional concerns with PAR.

   a. PAR has no notice requirements to partners of administrative or judicial proceedings;

   b. PAR affords partners no right to participate in administrative or judicial proceedings.

3. Constitutional issue: does Due Process Clause apply to require notice to partners of the audit proceeding and are partners "interested parties."

B. Due Process Concerns. Federal courts held that TEFRA did not deny partners due process because TEFRA included provisions requiring the IRS to give notice to certain classes of partners and to the tax matters partner.

1. *Kaplan v. U.S.*, 133 F.3d 469 (7th Cir. 1998) (no denial of due process where less than 1-percent partners were not provided notice).

   a. "[the Kaplans] challenge Section 6223(b)(1), which cuts off personal notice for partners who own less than one-percent shares in partnerships comprised of more than one hundred partners."

   b. "Although we agree that notice is the heart of due process…the Constitution does not require personal notice in every situation in which the Government action impacts a person's life, liberty, or property. Rather, due process is flexible and calls for such procedural protections as the particular situation demands."

c. TEFRA ruled constitutional because it "requires the tax mattes partner to keep all other partners informed of FPAA's or administrative proceedings."

2. *Walthall v. U.S.*, 131 F.3d 1289 (9th Cir. 1997) (no denial of due process where indirect partners not provided notice).

a. "We must determine whether … [TEFRA] is reasonably calculated, under the circumstances, to give indirect partners an opportunity to contest tax return adjustments."

b. TEFRA ruled constitutional because it requires TMP to keep all partners informed of administrative proceedings and requires pass-through partners to forward notices of proceedings to indirect partners. *See* Old Section 6223(g), (h)(2).

3. *1983 Western Reserve Oil & Gas Co., Ltd. v. Commissioner*, 95 T.C. 51 (1990) (noting that no denial of due process where not every partner is permitted to receive notice or to file petition).