

# How Much Must One Pay to Play? Recent Case Clarifies Jurisdictional Deposit Requirement in TEFRA Partnership Litigation

By Hale E. Sheppard

Hale Sheppard explains some of the tricky issues associated with the jurisdictional deposit obligation found in Code Sec. 6226(e)(1), noting that successfully defending oneself in a tax dispute involving a partnership requires a solid grasp of complex, dense and obscure rules, since these entities are often subject to a number of unique procedures.

## Introduction

Successfully defending oneself in a conventional tax dispute with the IRS necessitates a solid grasp of complex, dense and obscure rules. This knowledge requirement dramatically increases in tax controversies involving partnerships, as these entities are often subject to a number of unique procedures. Among these is the need to make a “jurisdictional deposit” before seeking review in certain courts of proposed adjustments by the IRS.

Most people are generally familiar with the *you-gotta-pay-to-play* concept, but the deposit rules in partnership actions are far from intuitive. This is evident from *Kislev Partners, L.P.*,<sup>1</sup> a recent case addressing, directly or indirectly, many of the tricky issues associated with the jurisdictional deposit obligation in Code Sec. 6226(e)(1).<sup>2</sup>

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## Overview of TEFRA Procedures

To appreciate the significance of the deposit requirement, one must first have a basic understanding of the audit and dispute-resolution procedures applicable to many partnerships.

Partnership items (such as partnership income, gain, deductions, losses, credits, *etc.*) pass through a partnership and are reported directly on the income tax returns of the partners.<sup>3</sup> The partnership must file an annual Form 1065 (U.S. Return of Partnership Income) indicating the partners to which items flowed, but the entity itself has no federal income tax liability. In other words, a partnership is a passthrough or conduit, not a taxable entity for federal income tax purposes.

For many years, there was no procedure in place that allowed the IRS to conduct a partnership-level audit. Therefore, the IRS was forced to scrutinize the tax positions taken by each of the partners; it was a partner-by-partner analysis. This dramatically changed in 1982 when Congress passed the Tax Equity and Fiscal Responsibility Act (TEFRA).<sup>4</sup> This legislation introduced partnership-level audit procedures, which

permitted the IRS to audit the entity itself, determine the appropriate adjustments, and then notify the partners of the tax effects of such adjustments on each of them based on their respective interests in the partnership.<sup>5</sup> In short, TEFRA enabled the IRS to focus its audits on the partnership, not the partners. This change made administrative sense: many of the audited partnerships, particularly those involving “tax shelters,” had numerous partners; the IRS had trouble locating and coordinating the income tax returns of each partner to ensure that they received consistent treatment; and the statute of limitations for each partner had to be individually monitored so that the assessment periods did not unexpectedly expire.

The procedures of a TEFRA partnership audit vary considerably from those utilized in a traditional audit of individuals or non-TEFRA entities, but the concepts are similar in both contexts. The IRS notifies the taxpayer that it has been selected for audit, it gathers information and documentation in the course of the audit, and it eventually issues a notice explaining the adjustments that it plans to make to the returns filed by the taxpayer. These proposed adjustments normally include increased taxes, as well as penalties and interest. If the taxpayer disagrees, it has the right to dispute the suggested increases administratively, *i.e.*, with the IRS Appeals Office. If the taxpayer and the IRS are unable to resolve the conflict at this level, then the IRS issues its final notice of proposed adjustments. This entitles the taxpayer to seek review by the courts.

In the case of a TEFRA audit, the ultimate notice from the IRS is called a notice of final partnership administrative adjustment (FPAA). The IRS is required to mail it first to the tax matters partner (TMP) for the partnership, followed by copies to all “notice partners” and representatives of “five-percent groups.”<sup>6</sup> Within 90 days of when the IRS mailed the FPAA, the TMP has the exclusive right to file a petition in any one of three courts—the U.S. Tax Court, proper U.S. District Court or Court of Federal Claims asking the court to hold that the IRS’s proposed adjustments are incorrect.<sup>7</sup> If the TMP does not file a petition within the 90-day period, then any notice partner or five-percent group may file a petition with any of the three courts within the next 60 days.<sup>8</sup>

## Jurisdictional Deposits Under Code Sec. 6226(e)(1)

There are advantages and disadvantages to bringing a TEFRA action in each of the three potential courts. One major consideration is the amount of upfront money involved. The Tax Court is a non-pre-payment forum; that is, the partner bringing the action on behalf of the partnership is *not* required to pay the proposed deficiency, or any portion thereof, before proceeding. In contrast, the partner initiating a case before a U.S. District Court or the Court of Federal Claims must first make a “jurisdictional deposit.” The key provision in this regard, Code Sec. 6226(e)(1), contains the following rule:

[T]he court granted Mr. Bahar 60 days to compensate for the jurisdictional deficit, which meant that he would have to deposit an additional \$2.89 million in order for Kislev to have its day in court.

A readjustment petition under this section may be filed in a district court of the United States or the Court of Federal Claims only if the partner filing the petition deposits with the Secretary, on or before the day the petition is filed, the amount by

which the tax liability of the partner would be increased if the treatment of partnership items on the partner’s return were made consistent with the treatment of partnership items on the partnership return, as adjusted by the final partnership administrative adjustment . . . The court may by order provide that the jurisdictional requirements of this paragraph are satisfied where there has been a good faith attempt to satisfy such requirements and any shortfall in the amount required to be deposited is timely corrected.<sup>9</sup>

The regulations under Code Sec. 6226(e) go on to add that the petitioning partner does not have to pay other outstanding liabilities (*i.e.*, deficiencies unrelated to the partnership) in order to satisfy the jurisdictional deposit.<sup>10</sup> In simplified terms, Code Sec. 6226(e)(1) and its regulations obligate a partner who intends to commence a TEFRA partnership action in either a U.S. District Court or the Court of Federal Claims to calculate how much his tax liability will increase if the court ultimately upholds the IRS’s proposed adjustments in the FPAA, and then pay this amount to the IRS no later than the day he files the

petition with the court. A basic example found in the regulations illustrates the deposit requirement.

A files a petition for readjustment of partnership items in the United States Court of Federal Claims. A's tax liability would be increased by \$4,000 if partnership items on A's return were conformed to the partnership return, as adjusted by the notice of final partnership administrative adjustment. A has an unpaid liability of \$10,000 attributable to nonpartnership items. A is required to deposit \$4,000 in order to satisfy the jurisdictional requirement.<sup>11</sup>

## Description of the Case

Like many tax rules, Code Sec. 6226(e)(1) is deceptively straightforward. A recent case, *Kislev Partners, L.P.*, shows how complex the issues surrounding this tax provision can be.

Kislev is a limited partnership involved in real estate development. It allegedly participated in a tax shelter known as a "distressed asset/debt" transaction, which generated an ordinary loss of approximately \$140 million in 2002. Kislev did not claim the entire loss on its Form 1065 (U.S. Return of Partnership Income) for 2002. Instead, it claimed an ordinary loss of some \$6.5 million and stated that the remaining loss of roughly \$134 million must be deferred to later years due to basis limitations.

Nesim Bahar was an "indirect partner" in Kislev. This means that he held an interest in Kislev through one or more passthrough partners, such as partnerships, estates, trusts, S corporations or nominees.<sup>12</sup> On his Form 1040 (U.S. Individual Income Tax Return) for 2002, Mr. Bahar claimed a loss flowing from Kislev of approximately \$655,000. He claimed significantly larger losses and net operating loss carryforwards on his Forms 1040 for 2003, 2004 and 2005.

The IRS audited Kislev and ultimately issued an FPAA making its typical claims in these types of cases: the transaction was a sham, it lacked economic substance and it was undertaken for purposes of avoiding payment of federal income taxes. The FPAA only proposed adjustments to partnership items on Kislev's Form 1065 for 2002, but it also disallowed the deferred loss of about \$134 million "finding that Kislev had not established any basis in these distressed assets." The FPAA also asserted accuracy-related penalties against Kislev based on various theories.

Apparently, the TMP for Kislev did not file a petition within the 90-day window because Mr. Bahar, in his capacity as an indirect partner, timely filed suit in the Court of Federal Claims challenging the FPAA. Mr. Bahar's federal income tax liability for 2002 would have been \$0 even if the FPAA were fully sustained by the court. Nevertheless, before filing suit, he made a jurisdictional deposit with the IRS of \$9,500 for 2002 "out of an abundance of caution."<sup>13</sup> Mr. Bahar did not make any deposits with respect to the subsequent years (*i.e.*, 2003, 2004 and 2005) in which he claimed large losses stemming from the distressed debt/asset transaction in which Kislev engaged in 2002.

According to the government's calculations, Mr. Bahar should have made a deposit in the amount of \$2.9 million dollars. This amount would have covered the increase in Mr. Bahar's federal income tax liability for 2002, 2003, 2004 and 2005 if the court were to validate the FPAA. Because Mr. Bahar's deposit was insufficient, argued the government, the case should be dismissed for lack of jurisdiction. Moreover, because Mr. Bahar acted in bad faith by paying less than one-half of one percent of the requisite deposit amount, the government urged the court not to grant Mr. Bahar an opportunity under Code Sec. 6226(e)(1) to pay additional amounts to make up any jurisdictional shortfall.

The court agreed with the government's principal contention that Mr. Bahar failed to make a sufficient deposit, but rejected its request for an immediate, full dismissal of the case. Rather, the court granted Mr. Bahar 60 days to compensate for the jurisdictional deficit, which meant that he would have to deposit an additional \$2.89 million in order for Kislev to have its day in court.

## Major Issues in the Case

The holding in *Kislev Partners, L.P.* is instructive in a general sense; however, like with so many tax cases, its true value comes from exploring all the issues that it raises, directly or indirectly. These issues, many of which are not immediately apparent, are examined below.

### For What Years Is the Deposit Required?

The FPAA issued by the IRS often addresses and proposes adjustments to multiple years. Thus, before bringing the TEFRA partnership action in the U.S. District Court or the Court of Federal Claims, the relevant

partner normally pays the increased tax liability with respect to *each* of the applicable years.<sup>14</sup> Courts have ruled, though, that it is not an all-or-nothing proposition; a partnership may dispute only one of the years raised in the FPAA and pay the corresponding deposit amount. For instance, in one case, the IRS issued an FPAA covering 1983 and 1984, yet the TMP filed a timely petition contesting only the suggested changes to the latter year. Regarding the deposit issue, the court stated that “since Petitioner was contesting only the 1984 FPAA, he need only pay the 1984 assessed deficiency, which Petitioner paid.”<sup>15</sup>

*Kislev Partners, L.P.* is unique in that the FPAA only adjusted the partnership items for 2002, but generally seemed to disallow any deferred losses claimed in later years on the theory that Kislev had not established that it had any tax basis in the distressed assets at issue. The court summarized the pertinent facts in the following manner:

Prior to filing its complaint, Plaintiff’s filing partner, Mr. Bahar, made a deposit of \$9,500 for purposes of satisfying section 6226(e)(1). In calculating this figure, Mr. Bahar included only his increased tax liability for the 2002 tax year the year for which the FPAA was issued and not the other years through which he carried over losses. Nevertheless, Mr. Bahar reported the losses disallowed by the FPAA in computing his personal tax liability not only for the 2002 tax year, but also for 2003, 2004 and 2005.

**Confusion regarding the amount due is further compounded by the fact that the terms “taxes” and “liability” include penalties and interest in certain parts of the Code.**

Citing the statutory language in Code Sec. 6226(e)(1), Kislev argued that Mr. Bahar was only required to pay “the amount by which the tax liability of the partner would be increased if the treatment of partnership items on the partner’s *return* were made consistent with the treatment of partnership items on the partnership *return*, as adjusted by the final partnership administrative adjustment.” Emphasizing the singular form of “return” as opposed to the plural form of “returns,” Kislev contended that Code Sec. 6226(e)(1) cannot be interpreted to require a deposit based on the tax liability for multiple years.

The government had its own interpretation of the same portion of Code Sec. 6226(e)(1). It suggested

that the emphasis should be on the phrase “tax liability,” such that the provision should be read to say that “the amount by which the *tax liability* of the partner would be increased if the treatment of partnership items on the partner’s return were made consistent with the treatment of partnership items on the partnership return, as adjusted by the final partnership administrative adjustment.”

The court rejected Kislev’s argument for three main reasons, the most interesting of which is an expansive construction of Code Sec. 6226(e)(1) based on congressional purpose. The court indicated that allowing a petitioning partner to make no jurisdictional deposit and still obtain jurisdiction would undercut legislative intent. In this regard, the court stated:

Plaintiff’s interpretation that it need only deposit the tax liability for the single year in which the FPAA was issued would stand the statute on its

head, since the petitioning partner has incurred no tax liability for the year of the FPAA and would require no deposit in contradiction to the basic statutory premise . . . Mr. Bahar’s *total tax liability* reflected in the FPAA

is not zero it is some \$2.9 million. Mr. Bahar’s election to defer his tax losses to future years and thus incur no FPAA-related tax liability for 2002, should neither dictate the amount of his deposit reducing it to nothing nor undermine the primary statutory purpose of §6226(e)(1) which equates the amount of that deposit with total tax liability. (Emphasis added.)

Lest there be any ambiguity, the court later summarized its position. In doing so, the court essentially added the word “total” before “tax liability” in Code Sec. 6226(e)(1).

In sum, to invoke this Court’s jurisdiction under section 6226(e)(1), a partner filing a readjustment petition must deposit the full amount of the partner’s increased tax liability. In calculating this amount, the filing partner must include his increased tax liability *for all years in which his individual returns are affected by adjustments to partnership items in the FPAA.* (Emphasis added.)

## Is Paying Nothing Enough?

Previous cases indicate that certain U.S. District Courts and possibly the Court of Federal Claims would allow a petitioning partner to obtain jurisdiction without making any deposit whatsoever under Code Sec. 6226(e)(1), if such partner's federal income tax liability would still be \$0 if the court were to uphold the proposed adjustments in the FPAA. For example, the court in *M. Benedict*,<sup>16</sup> noted the following:

All Plaintiffs have satisfied the requirements of §6226(e)(1) of the Code by making the required good-faith deposits with the Internal Revenue Service of their respective portions of the additional tax liabilities set forth in the Notices, *or have not made any deposit with the Internal Revenue Service because they would have no tax liability for the [relevant] period . . . even if the adjustments in the partnership tax returns were upheld.*<sup>17</sup>

As discussed in the previous portion of this article, the holding in *Kislev Partners, L.P.* broadly interprets Code Sec. 6226(e)(1) to demand that a petitioning partner deposit an amount equal to his increased tax liability for all tax years during which his Form 1040 (U.S. Individual Income Tax Return) would be impacted by any adjustments to partnership items described in the relevant FPAA. This holding is unambiguous, but related issues remain murky. In particular, can a petitioning partner satisfy Code Sec. 6226(e)(1) by making a deposit of \$0 if he would not have any "total tax liability" thanks to losses unrelated to the issues raised in the FPAA? The decision in *Kislev Partners, L.P.* discusses the fact that Mr. Bahar's increased tax liability for the year of the FPAA would remain \$0, yet the precedential impact of this discussion is uncertain. Does this case diverge from the tacit approval of \$0 deposits in *M. Benedict* and others?

## How Much Must an Indirect Partner Deposit?

The decision in *Kislev Partners, L.P.* focused on Mr. Bahar, but it did not pay undue attention to the fact that he filed suit on behalf of the partnership as an "indirect partner." Remember, Mr. Bahar was the sole member/partner in a passthrough entity that, in turn, was a partner in *Kislev*. Although not of particular relevance to this case, being an indirect partner may have a significant effect in other litigation.

As explained above, Code Sec. 6226(e)(1) provides that a TEFRA action may be brought in the proper U.S.

District Court of the Court of Federal Claims only if the partner filing the petition deposits with the IRS, on or before the day the petition is filed, the amount by which such partner's tax liability would increase if the proposed adjustments in the FPAA were deemed correct. It goes on to expressly state that, in the case of a petition filed by a representative of a five-percent group, the deposit requirement applies to *each member of the group*, not just to the representative. Code Sec. 6226(e)(1) is conspicuously silent with respect to petitions filed by passthrough entities (such as partnerships, estates, trusts, S corporations and nominees) that are partners in the partnership being scrutinized by the IRS. So-called tiered structures are common nowadays, and they have been addressed by regulations.

As originally drafted, the applicable regulations, like Code Sec. 6226(e)(1) itself, did not discuss how passthrough petitioning partners would satisfy the jurisdictional deposit requirement. This question is fundamental for the following reason, which people frequently overlook. Code Sec. 6226(e)(1) requires payment of the amount by which the tax liability of the petitioning partner would be increased if the treatment of partnership items on the partner's return were made consistent with the partnership items on the partner's Form 1065, as adjusted by the FPAA. The challenge is that passthrough entities are not taxable entities; therefore, changes to the partnership's Form 1065, which would flow through to the petitioning partner's Form 1065, would have no income tax effect on the passthrough partner itself. The changes would only impact the taxable owners up the line. To account for this, the regulations were amended in 2001 to expressly state that, in the case of a petition filed by a passthrough entity, *each indirect partner* holding an ownership interest by way of the passthrough partner must pay the appropriate jurisdictional amount.<sup>18</sup> At least one case has applied this revised language.<sup>19</sup>

## Does the "Tax Liability" Include Penalties?

An FPAA issued by the IRS ordinarily proposes to increase taxes. It often asserts hefty penalties and interest, too. Code Sec. 6226(e)(1) indicates that the petitioning partner must make a jurisdictional deposit equal to the amount by which his "tax liability" would increase, assuming the FPAA were correct. This provision does not specify, though, what items comprise "tax liability." Confusion regarding the amount due is further compounded by the fact that the terms

“taxes” and “liability” include penalties and interest in certain parts of the Code.<sup>20</sup>

Research has not revealed any cases directly on point, but *Kislev Partners, L.P.*, like other TEFRA cases, indirectly addresses the issue. In its motion to dismiss, the government’s computation regarding the proper deposit from Mr. Bahar did not include penalties and interest, and the court agreed.

Defendant [government] calculates the required deposit to be \$2,905,046, *exclusive of penalties and interest*, based upon the tax liability for these three outlying years. Because the statute requires a deposit of the total tax liability and not only the liability in the year the FPAA was issued, the Court concludes that the required deposit was \$2,905,046. (Emphasis added.)

Support for the proposition that the petitioning partner is not required to front the penalties and interest is found elsewhere. For example, the Internal Revenue Manual clearly states in its section on actions in the U.S. District Court and the Court of Federal Claims that “[i]nterest and penalties do not need to be deposited.”<sup>21</sup>

This notion is strengthened by the legislative history. Congress made several changes to the TEFRA procedures as part of the Taxpayer Relief Act of 1997.<sup>22</sup> Notably, it modified the initial provision, Code Sec. 6221, which dictates the scope. Code Sec. 6221 originally stated that “the tax treatment of any partnership item shall be determined at the partnership level.” In 1997, it was broadened to state that “the tax treatment of any partnership item (and the applicability of any penalty, addition to tax or additional amount which relates to such an adjustment to a partnership item) shall be determined at the partnership level.” After making this change to Code Sec. 6221, Congress also made various conforming amendments to other TEFRA provisions. For instance, it expanded Code Sec. 6226(f), which deals with the scope of judicial review, to expressly state that the courts had authority to determine “the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.”

Congress had the opportunity, but decided not make similar changes to Code Sec. 6226(e). This inaction with respect to Code Sec. 6226(e) and the jurisdictional deposit did not go unnoticed. The current regulations do not address the penalty issue; however, the preamble to those regulations provides the following guidance.

The 1997 Act [Taxpayer Relief Act of 1997] grants courts jurisdiction to determine penalties, additions to tax, or additional amounts relating to an adjustment to partnership items. The final regulations do not, however, amend §301.6226(e)-1T to require that a partnership contesting an FPAA, in a United States district court or the United States Court of Federal Claims, deposit tax attributable to partnership-level determinations of penalties as a condition of bringing the proceeding. Because the 1997 Act amends section 6226(f), but not section 6226(e), it appears that Congress did not intend to require a deposit of penalties attributable to partnership-level determinations as a condition of bringing such an action.<sup>23</sup>

### Did the Mistaken Petitioning Partner Act in Good Faith?

This article demonstrates, among other things, that determining the proper jurisdictional deposit can be difficult. Perhaps it is for this reason that Code Sec. 6226(e)(1) allows some room for error. In particular, it authorizes the U.S. District Court or Court of Federal Claims to find that the jurisdictional requirement has been met where the petitioning partner makes a “good faith attempt” to satisfy the rule and then “timely corrects” any shortfall in the deposit amount. The government has tried to persuade the court on several occasions that a taxpayer acted in bad faith and thus warranted no additional leeway.

For instance, in *Span Hansa Management Co.*,<sup>24</sup> the TMP of the partnership brought an action in the proper U.S. District Court challenging an FPAA for 1986 and 1987. The government primarily argued that case should be dismissed because the TMP failed to pay the deposit amount fully. The FPAA had two major theories: (1) The partnership was a sham designed to allow the partners to avoid paying federal income tax; therefore, all of the income from the partnership should be attributed to the partners; and (2) all of the partnership losses should be disallowed because of insufficient substantiation. The TMP interpreted the FPAA to mean either that all partnership income should be allocated to him or, alternatively, that all partnership losses should be disallowed. In other words, he read the FPAA in the disjunctive, as opposed to the conjunctive. Before filing the petition, the TMP called the revenue agent, who confirmed his interpretation of the FPAA. The TMP made his deposit accordingly. The court recognized that the FPAA was “poorly drafted” and “somewhat confusing,” and that the TMP reasonably relied on the statements by the revenue

agent. The parties ultimately agreed that the TMP acted in good faith, and the court granted the TMP a period of 90 days to cover any depository shortfall.

The parties were slightly less amicable in *Maarten Investerings*.<sup>25</sup> The government filed a motion to dismiss for lack of jurisdiction under Code Sec. 6226(e)(1), arguing that the TMP negligently calculated the deposit amount because it should have been “straightforward” and “uncomplicated” for a tax professional. The government further contended that the TMP’s actions smacked of bad faith because the TMP declined to adequately review with the revenue agent what the correct deposit amount should have been, despite being “invited” to do so. The court, finding it unnecessary to determine whether the term “good faith” in Code Sec. 6226(e)(1) should be determined by applying a subjective or objective test, held in favor of the TMP. Specifically, the court found that the TMP did not lack good faith, even though the TMP failed to reach a pre-filing agreement with the IRS as to the amount of the deposit because of “tactical maneuvers.” The court then afforded the TMP an additional 60 days to rectify the deposit issue.

Most recently, the government argued in *Kislev Partners, L.P.* that Mr. Bahar should have made a deposit in the amount of \$2.9 million dollars, he paid less than one-half of one percent of the proper deposit amount, such a huge shortfall evidences his bad faith, and he should be deprived of any opportunity to remedy this situation by depositing additional amounts. The court rejected the government’s contention. Referencing both *Span Hansa Management* and *Maarten Investerings Partnership*, the court found that Mr. Bahar’s calculation was based on a “reasonable, albeit erroneous, interpretation of the law,” that he offered a “reasonable explanation” for the mistaken calculation, and that he deserved 60 days to pay the additional amounts to obtain jurisdiction.

### **Can the IRS Proceed with Assessment and Collection Despite the Deposit?**

One of the most interesting issues about *Kislev Partners, L.P.*, as well as numerous other partnership cases before the U.S. District Court or Court of Federal Claims, is one that was never addressed.

Under the TEFRA rules, certain partners may file a petition challenging the FPAA in the Tax Court, the proper U.S. District Court, or the Court of Federal Claims. The first does not necessitate a deposit; it is a non-pre-payment forum. The latter two require a toll charge, a jurisdictional deposit. There are numerous

strategic reasons for selecting one litigation forum over another, and they are beyond the scope of this article. One thing that is certain, though, is that when partnerships opt to seek justice in the U.S. District Court or the Court of Federal Claims, they generally want to keep the upfront costs as low as possible. Therefore, when identifying which partner will file suit on behalf of the entity, seasoned tax professionals review the levels of ownership interest. Putting other factors aside, logic dictates that the eligible partner (or partners in the case of suits by five-percent groups and passthrough partners) with the smallest interest would file suit to reduce the jurisdictional deposit.

This sounds plausible at first blush, but a closer review of the TEFRA provisions and legislative history may undermine this approach. Code Sec. 6225(a) contains the following rule regarding tax assessment and collection in TEFRA partnership cases.

Except as otherwise provided in this subchapter, no assessment of a deficiency attributable to any partnership item may be made (and no levy or proceeding in any court for the collection of any such deficiency may be made, begun, or prosecuted) before (1) the close of the 150th day after the day on which [an FPAA] was mailed to the tax matters partner, and (2) if a proceeding is begun *in the Tax Court* under Section 6226 during such 150-day period, the decision of the court in such proceeding has become final. (emphasis added).

In plain English, Code Sec. 6225(a) generally provides that the IRS may not assess a deficiency attributable to any partnership item and may not take any related collection actions until the court decision becomes final, provided that the TEFRA proceeding was brought “in the Tax Court.” The absence of the U.S. District Court and the Court of Federal Claims from this provision is significant. In essence, the restriction on assessments related to partnership adjustments against all partners applies only if the petition is filed in the Tax Court. If it is filed in either of the other two courts, Code Sec. 6225(a) does not appear to protect all partners. Thus, the IRS theoretically could proceed to assess the deficiency in the FPAA against *all* partners, even if a timely petition was filed in the U.S. District Court or Court of Federal Claims and the appropriate deposit was paid by the petitioning partner.

Background on this issue is sparse, yet fairly straightforward. According to the relevant congressional conference report, “the Secretary may assess and collect any deficiencies of other partners resulting from the

FPAAs if jurisdiction is established in the District Court or Claims Court pending a decision on the merits.<sup>26</sup> Likewise, a report from the U.S. Joint Committee on Taxation states that “[a] partner filing in any forum other than the Tax Court must first pay the deficiency resulting from adjustments to his return to reflect the FPAAs. Other partners, where the forum is not the Tax Court, are subject to assessment and collection.”<sup>27</sup>

While empowered to take such assessment and collection actions, the IRS rarely follows this course of action. Why? Probably because the IRS’s economic interests are not jeopardized by waiting until after the litigation has been resolved. Code Sec. 6229(a) generally provides that the period for assessing taxes on any person that are attributable to a partnership item or an affected item will not expire until three years after the date on which the partnership’s Form 1065 was filed or the due date for filing the Form 1065 (excluding extensions), whichever is later. Code Sec. 6229(d) contains special rules in cases where the IRS audits the partnership and proposes adjustments. Under this provision, if the IRS mails an FPAAs to the TMP, then the general three-year assessment period described in Code Sec. 6229(a) is suspended for the 150-day period during

which a partner may challenge the FPAAs by bringing an action in the Tax Court, proper U.S. District Court, or Court of Federal Claims (and, if a partner actually files such an action, until the court decision becomes final), plus one year thereafter.

## Conclusion

As demonstrated by *Kislev Partners, L.P.*, the ostensibly simple rule that the petitioning partner in a TEFRA case before a U.S. District Court or the Court of Federal Claims must pay to play is anything but simple. Code Sec. 6226(e)(1), like many of the TEFRA partnership rules, is complicated and dynamic; it continuously changes as the courts apply and interpret it. Moreover, Code Sec. 6226(e)(1) is fundamental, as an action may be dismissed by the court for failure to make the appropriate jurisdictional deposit. Few things could be worse for a partnership under siege by the IRS than to be deprived of its day in court due to a technicality. In light of the (unappreciated) complexity of Code Sec. 6226(e)(1), partners would be wise to consult tax professionals who regularly handle TEFRA disputes before taking the IRS to task.

## ENDNOTES

<sup>1</sup> *Kislev Partners, L.P.*, FedCl, 2008-2 USTC ¶50,490.

<sup>2</sup> Unless otherwise stated, all uses of the term “Code Sec.” or “Code Secs.” refer to the Internal Revenue Code of 1986, as amended.

<sup>3</sup> Code Sec. 6231(a)(3) and Reg. §301.6231(a)(3)-1.

<sup>4</sup> Tax Equity Fiscal Responsibility Act (TEFRA) of 1982 (P.L. 97-248).

<sup>5</sup> Code Secs. 6221 through 6234.

<sup>6</sup> Code Sec. 6223(a)(2); Code Sec. 6223(d).

<sup>7</sup> Code Sec. 6226(a).

<sup>8</sup> Code Sec. 6226(b).

<sup>9</sup> See also H.R. CONF. REP. NO. 97-760, 97th Cong., 2d Sess. (Aug. 17, 1982), pgs. 603-604; Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, JCS-38-82 (Dec. 31, 1982), pg. 272.

<sup>10</sup> Reg. §301.6226(e)-1(a)(1).

<sup>11</sup> Reg. §301.6226(e)-1(a)(2).

<sup>12</sup> Code Secs. 6231(a)(9), (10). *Kislev* was owned by three limited liability companies

(treated as partnerships for federal income tax purposes) and one individual. Mr. Bahar was the sole owner of one of the three partnerships. Based on the figures in the court’s decision, it appears that Mr. Bahar indirectly owned 10 percent of *Kislev*.

<sup>13</sup> See *supra* note 1, *Kislev Partners, L.P.* at fn. 2. The case is unclear regarding the basis on which Mr. Bahar calculated the \$9,500 amount.

<sup>14</sup> See, e.g., *Transcapital Leasing Associates 1990-II, LP*, DC Tex., 2006 U.S. Dist. LEXIS 16238, 97 AFTR 2d 2006-1916.

<sup>15</sup> *Georgetowne Sound*, DC Md., 93-2 USTC ¶50,378, 856 F.Supp 1056.

<sup>16</sup> *M. Benedict*, DC Utah, 95-1 USTC ¶50,320, 881 F.Supp 1532.

<sup>17</sup> See *supra* note 1, *Kislev Partners, L.P.* (emphasis added). See also *Russian Recovery Fund Ltd.*, FedCl, 2008-1 USTC ¶50,354, 81 FedCl 793, fn. 2 and fn. 3 (2008).

<sup>18</sup> T.D. 8965, 2001-2 CB 344, 66 Fed. Reg. 50541 *et seq.* (Oct 3, 2001); Reg.

§301.6226(e)-1(a)(1).

<sup>19</sup> *Natalie Holdings, Ltd.*, DC Tex., 2003-1 USTC ¶50,233, fn. 3 (W.D. Tex. 2003) (explaining that “[b]ecause the tax matters corporation, DAVMY, is an ‘S-Corporation,’ the shareholders, David and Amy Perez, are required to make tax deposits rather than the corporation pursuant to 26 U.S.C. §§1366-1368.”)

<sup>20</sup> See, e.g., Code Sec. 6201(a).

<sup>21</sup> I.R.M. 8.19.3.13.3 (06-01-2007).

<sup>22</sup> P.L. 105-34.

<sup>23</sup> T.D. 8965 (Preamble), 2001-2 CB 344, 66 Fed. Reg. 50544 (Oct. 3, 2001).

<sup>24</sup> *Span Hansa Management Co.*, DC Wash., 91-1 USTC ¶50,213.

<sup>25</sup> *Maarten Investering Partnership*, DC N.Y., 2000-1 USTC ¶50,241.

<sup>26</sup> H.R. Conf. Rep. No. 97-760, 97th Cong., 2d Sess. (Aug. 17, 1982), pg. 604.

<sup>27</sup> Joint Committee on Taxation, *Summary of the Revenue Provisions of H.R. 4961 (The Tax Equity and Fiscal Responsibility Act of 1982)*, JCS-31-82 (Aug. 24, 1982), pg. 60.

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