Tax Controversy Corner

By Megan L. Brackney

Will I Be Sued? Potential Civil Liability of the Tax Matters Partner

The tax matters partner ("TMP") of a TEFRA[1] partnership has important duties where there is an IRS audit or controversy. One question that TMPs ask is whether a failure (or a perceived failure) to perform these duties will subject him or her to civil liability. The answer to this question is not at all clear, and for this reason, the best course for the TMP is to enter into a hold harmless or indemnification agreement with the other partners.

The TMP is required to keep each partner informed of all administrative and judicial proceedings for the adjustment of partnership items.[2] This includes providing information to the partners regarding closing conferences with the revenue agent, proposed adjustments, rights of appeal and filing a protest, the time and place of Appeals conferences, acceptance of settlements by the IRS, consent to extension of the statute of limitations on assessment, filing of a request for administrative adjustment, filing of any petition for judicial review, appealing judicial determinations and final judicial redetermination.[3]

The TMP also has independent authority to act on behalf of the partnership in several key respects. The TMP has authority to execute an extension of the statute of limitations for assessment with respect to partnership items and affected items of all partners in the partnership.[4] The TMP also has authority to enter into settlement agreements on behalf of the partnership.[5] If the matter does not settle during audit or Appeals and the IRS issues a notice of the Final Partnership Administrative Adjustment ("FPAA"), the TMP has the authority to determine whether the partnership should challenge those adjustments in the Tax Court, U.S. District Court or the U.S. Court

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of Federal Claims.[6] And during judicial proceedings, the TMP has the authority to make strategic decisions in the litigation, including whether to settle the case.[7] In addition to the statutory duties imposed by TEFRA, TMPs also have a common-law fiduciary duty to the other partners.[8]

Does the TMP's Failure to Perform These Duties Subject Him or Her to Civil Liability?

As an initial matter, it is not a settled question whether the TMP could be civilly liable for not satisfying his or her obligations under TEFRA itself. In an unpublished decision in *Arvin v. Go Go Inv.*,[9] the Court of Appeals for the Ninth Circuit rejected the plaintiff's argument that the TEFRA provisions of the Code created an implied private cause of action. The Ninth Circuit cited to the Supreme Court's decision in *Cort v. Ahs*,[10] which articulated a four-part test to determine whether a statute creates an implied cause of action: (1) is the plaintiff one of the class for whose "especial benefit" the statute was enacted; (2) does the legislative history create or deny such a remedy; (3) is an implied cause of action consistent with the purposes of the legislative scheme; and (4) is the cause of action one so traditionally relegated to state law that "it would be inappropriate to infer a cause of action based solely on federal law?" The Ninth Circuit explained that an individual partner is not a part of a class for whose "especial benefit" the Internal Revenue Code ("the Code") was enacted, as it was enacted for the benefit of the government and that there is nothing in the legislative history of the TEFRA provisions showing any intent to create a private cause of action.

This reasoning is somewhat in conflict with that of *Transpac*, which, in holding that TMPs have a fiduciary relationship to the individual partners, seems to suggest that TEFRA's TMP provisions do, in fact, create an "especial benefit" for TEFRA partners:

> By centralizing tax-related proceedings of the partnership in one person or entity, Congress created a statutory analogue of the class representative in class action proceedings. And just as class members, though entitled to due process safeguards, can be bound by the results of a proceeding to which they are non-parties because the class representatives owe them fiduciary duties, so the limited partners secure their due process protection as a result of the fact that the TMP stands in a fiduciary relationship toward them. We conclude that the TMP's duty to the individual limited partners and to the partnerships in general is beyond question.[11]

Based on the *Transpac* reasoning, a disgruntled partner may be able to argue that TEFRA created a private right of action under the *Cort* test, particularly since the only authority to the contrary is an unpublished decision. In any event, to date, no court has held that TEFRA created an implied right of action such that a TMP is subject to civil liability for not fulfilling his or her obligations under TEFRA.

> In most cases, it is unlikely that a tax matter partner acting in good faith will be civilly liable to partners who are unhappy with the result in their TEFRA tax controversy.

However, there may be causes of action under state law against a TMP who violates his or her fiduciary duty (as opposed to violating TEFRA). In order to determine whether a TMP has violated his or her fiduciary duty requires consideration of the applicable state law regarding the standard of care of partners, which varies widely from state to state. The Revised Uniform Partnership Act formulates the partners' fiduciary duties as the duties of care and loyalty, which require partners to refrain from "engaging in grossly negligent or reckless conduct, intentional misconduct, or knowing violation of law."[12]

In most jurisdictions, courts apply the "business judgment rule," to limit a partner's liability for breach of fiduciary duty to the partnership. The "business judgment rule," which developed in the corporate governance context, has been expressed as follows:

> The business judgment rule provides that questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to [the directors'] honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the

> common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.[13]

The business judgment rule, of course, does not insulate partners from decisions motivated by fraud or bad faith.[14] At least one state legislature has explicitly applied the business judgment rule to partnerships through statute,[15] and in other states, the application of the business judgment rule to partnerships has evolved through case law.[16]

Within this framework, when would a TMP be civilly liable for breach of fiduciary duty? In most cases, it is unlikely that a TMP acting in good faith will be civilly liable to partners who are unhappy with the result in their TEFRA tax controversy. The choice of forum to challenge a partnership adjustment and the decision to settle with the IRS would seem to be a "classic exercise of business judgment."[17]

If the TMP Is Determined to Have Civil Liability, What Are the Potential Damages?

This leads us to the next question: Assuming there is potential for a cause of action against the TMP, what are the damages? Whether there is liability for increased taxes depends on whether the taxes were avoidable but for the TMP's failure to discharge his or her duties.[18] For example, if the TMP's failure to communicate caused the partnership to miss its opportunity to challenge the FPAA and the partnership only learned about the partnership adjustment after the commencement of collection proceedings, damages for increased taxes may be appropriate if the partnership owed more tax as a result of the failure to challenge the FPAA. This would depend on whether the FPAA was valid and the adjustments were correct. In order for damages to be awarded, however, the amount of increased tax caused by the TMP's failure to comply with TEFRA or his or her breach of fiduciary duty cannot merely be speculative.

Along with the increased tax, a partner may recover penalties imposed by the IRS. As stated by one commentator in the context of malpractice suits against tax advisors, "the incurrence of a penalty is simply damages flowing directly from the tax advisor's negligence, and the recovery of such amounts is not controversial." [19]

Next, in some jurisdictions the disgruntled partners may make a claim for interest on the increased tax. There are three views with respect to the recoverability of interest on a tax underpayment:

> According to the view that is probably the majority view, such interest is recoverable from a defendant just like any other damages proximately caused. A second view, diametrically opposite and likely the minority view, absolutely prohibits the recovery of such interest. A third view, a middle view followed in several states, permits the recovery of such interest, but only to the extent it exceeds the interest actually earned by the plaintiff on the underpaid taxes.[20]

These cases arise in the context of attorney or accountant malpractice, but would apply equally in a suit against a TMP for damages. The first view, which is the majority view, is that interest on the underpayment of tax "is recoverable from a defendant just like any other damages proximately caused."[21] The second view, which does not allow recovery of interest, is based on the premise that because the plaintiff had the use of the money during the period of late payment or underpayment, he or she is not damaged when he or she is ultimately required to pay interest for such use of the money.[22] The third view, adopted by some states,[23] is a compromise between the first two views, and allows a plaintiff to recover where a plaintiff earned some interest on the tax underpayment, but less than the amount paid to the IRS.

Finally, the TMP may be liable for corrective costs. The "American Rule" generally prohibits recovery of legal fees incurred in bringing a lawsuit, but costs, including attorney's fees incurred in trying to correct a tax liability, are recoverable.[24]

How Can the TMP Avoid Civil Liability?

In order to avoid the uncertainty of whether the TMP can be sued under TEFRA itself or whether his or her actions will be insulated by the business judgment rule, a TMP can mitigate the possibility of a lawsuit by including a "hold harmless" or indemnification provision in the partnership agreement, such as the following example:

> The "Tax Matters Partner" shall be reimbursed by the Company for all reasonable expenses actually incurred by the "Tax Matters Partner" in

> connection with its performance of its duties as such, and the Company shall indemnify and hold harmless the "Tax Matters Partner," to the maximum extent permissible. . . ., from and against any and all losses, claims, liabilities, costs and expenses incurred by the "Tax Matters Partner" in connection with its performance of its duties as such, except insofar as the same may have been incurred by reason of gross negligence or willful misconduct of such "Tax Matters Partner."[25]

Although a provision like this will not protect a TMP who acts in bad faith or with gross negligence or willful misconduct, it will protect the TMP who attempts, in good faith, to act in the best interest of the partnership.

ENDNOTES

1 TEFRA refers to the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) ("TEFRA"), set forth in Code Secs. 6221–6233. TEFRA established uniform procedures for determining the tax treatment of partnership items on audit and for obtaining judicial review of those determinations.

2 Code Sec. 6223(g) ("[t]o the extent and in the manner provided by regulations, the tax matters partner of a partnership shall keep each partner informed of all administrative and judicial proceedings for the adjustment at the partnership level of partnership items."); Reg. §§301-6223(g)-1(a)-(b).

3 If there is a petition filed in the Tax Court, the TMP is required to timely notify all partners of the petition and the docket number and must provide a copy of the petition to any partner that requests one. Tax Court Rules 241(f)(1) & (2); 242(g).

4 Code Sec. 6229(b).

5 Code Sec. 6224(c). There are exceptions to this rule: the TMP cannot bind a notice or partner who is a member of a notice group, as defined in Code Sec. 6223(b)(2), or any partner who has filed a statement not to be bound by any TMP settlement. Code Sec. 6224(c); Reg. §301.6224(c)-1(a).

6 Code Sec. 6226(a).

7 *A. Kaplan*, CA-7, 98-1 USTC ¶50,129, 133 F3d 469; *S. Hirshfield*, DC-NY, 2001-2 USTC ¶50,480, *on reconsideration*, CA-2, 2002-1 USTC ¶50,109, 177 FSupp. 2d, *aff'd*, 70 FApp'x 609; Tax Court Rule 248.

8 *R.K. Phillips*, 114 TC 115, Dec. 53,769 (2000); *Transpac Drilling Venture 1982-12*, CA-2, 98-2 USTC ¶50,517, 147 F3d 221.

9 *Arvin v. Go Go Inv. Club*, CA-9, 1997 U.S. App. LEXIS 32141.

10 *Cort v. Ahs*, 422 US 66, 78, 95 SCt 2080, 2088 (1975).

11 *Transpac Drilling Venture 1982-12*, note 8, *supra* (internal citation omitted).

12 Act Sec.404, Revised Uniform Partnership Act of 1997.

13 *Auerbach v. Bennett*, 393 NE2d 994, 1000 (N.Y. 1979) (internal citation omitted).

14 *Kuznik v. Bees Ferry Associates*, 342 SC 579, 603, 538 SE2d 15, 27 (S.C. Ct. App. 2000) (the business judgment rule will not apply if the partners have engaged in self-dealing, fraud, or other unconscionable conduct) (citing *Dockside Ass'n, Inc. v. Detyens*, 291 SC 214, 217, 362 SE2d 874 (S.C. 1987) (citing *Papalexiou v. Tower West Condominium*, 167 NJ Super 516, 528, 401 A2d 280, 286 (N.J. Super. 1979)); *Rosenthal v. Rosenthal*, 543 A2d 348, 353 (Me. 1988).

15 *See* Tex. Rev. Civ. Stat. Ann. Art. 6132b-4.04(c) (Vernon Supp. 2003).

16 *Kuznik*, note 14, *supra*, 528 SE2d at 27; *Lichtyger v. Franchard Corp.*, 18 NY2d 528, 536, 223 NE2d 869, 973 (1996); *Wallner v. Parry Prof'l Bldg., Ltd.*, 22 CalApp4th 1446, 1453 (1994); *Borys v. Rudd*, 566 NE2d 310, 316 (Ill. App. 1990); *Rosenthal*, note 14, *supra*, 543A2d at 353 (collecting cases); *see also* Elizabeth S. Miller and Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable decisions: The Business Judgment Rule in Unincorporated Business Organizations?*, 30 DEL. J. CORP. L. 343, 374-75 (2005) (collecting cases in which courts have applied formulations of the business judgment rule to partnerships). In one case, the court declined to apply the business judgment rule, stating that "the business judgment rule also is inapposite in the partnership context because it is a function of the unique corporate setting." *Henkels & McCoy, Inc. v. Adochio*, CA-3, 138 F3d 491 (1998). Although this is a minority view, and the Third Circuit does not provide much analysis of its rationale, federal courts in the Third Circuit appear to have adopted its approach. *See, e.g., Minard v. Iazzetti*, 2007 U.S. Dist. LEXIS 35331 (D.N.J. May 15, 2007); *Weaver v. Mobile Diagnostech, Inc.*, 2007 U.S. Dist. LEXIS 63409 (W.D. Pa. Apr. 30, 2009).

17 *Freedman v. Adams*, 58 A3d 414, 417 (Del. 2013) (describing a corporate board's decision not to implement a particular tax plan).

18 *See, e.g., Thomas v. Cleary*, 768 P2d 1090, 1092 n.5 (Alaska 1989); *see also O'Bryan v. Ashland*, 717 NW2d 632, 633 (S.D. 2006) ("In ordinary circumstances ... the taxpayer cannot recover as damages the tax deficiency itself because the tax liability arose not from the negligent advice, but from the ongoing obligation to pay the tax.").

19 Jacob L. Todres, Tax Malpractice Damages: A Comprehensive Review of the Elements and the Issues, 61 TAX LAW. 705, 723 (Spring 2008).

20 *Id.* at 723; *see also, e.g., Estate of Smith v. Underwood*, 487 SE2d 807, 815 (N.C. App. 1997).

21 Note 19, *supra*, 61 TAX. LAW 724–25 (collecting cases).

22 *See Frank v. Lockwood*, 275 Neb. 735, 744, 749 NW2d 443, 451-52 (Neb. 2008); *Eckert Cold Storage, Inc. v. Behl*, 943 FSupp.1230 (E.D. Cal. 1996); *Leendertsen v. Price Waterhouse*, 916 P.2d 449 (Wash. App. 1996); *Alpert v. Shea Gould Climenko*, 160 AD2d 67, 559 NYS2d 312 (N.Y. App. 1st Dep't 1990); *Orsini v. Bratten*, 713 P2d 791 (Alaska 1986).

23 *Streber v. Hunter*, CA-5, 221 F3d 701, 734–35 (2000); *Ronson v. Talesnick*, DC-NJ, 33 FSupp2d 347, 353–54 (1999).

24 For example, in *Sorenson v. Fio Rito*, 90 IllApp3d 368, 372, 413 NE2d 47, 52 (Ill. App. 1980), in a malpractice action, the court allowed recovery of fees paid to an attorney to obtain refunds of tax penalties which were assessed against the plaintiff as a result of the defendant attorney's negligence.

25 Dimitri P. Racklin, *A Practical Guide to Massachusetts Limited Liability Companies*, Appendix, "LLCs That Look and Feel Like Corporations: When and How," Massachusetts Continuing Education, Inc. (2011).