

Tax Controversy Corner

By Megan L. Brackney

Hit the Road, Jack: Changing the Tax Matters Partner

There are many situations where a partnership may want to change its Tax Matters Partner (“TMP”). Treasury Regulations and case law describe circumstances such as the death, dissolution, bankruptcy or criminal prosecution of the TMP where the TMP designation is automatically terminated. The partnership also may have other reasons for wanting to change its TMP, including conflicts of interest or lack of faith in the TMP’s ability to discharge his or her duties or in the TMP’s judgment. This column describes the procedures for termination and replacement of the TMP before the IRS and after a partnership matter has been docketed in Tax Court.

The Importance of the TMP

In an effort to simplify the procedures for determining the tax liability of individual partners in a partnership, Congress amended the Internal Revenue Code (“the Code”) as part of the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”). These provisions, set forth in Code Secs. 6221–6233, establish procedures for determining the tax treatment of partnership items on audit and for obtaining judicial review of those determinations. The TMP plays a vitally important role in a TEFRA partnership. The TMP is “the central figure of partnership proceedings” and “serves as the focal point for service of all notices, documents and orders of the partnership.”¹ Moreover, the TMP is required to keep the other partners informed of the administrative and judicial proceedings and serve as the representative of all partners before the IRS.² The TMP is responsible for initiating judicial proceedings and has authority to bind the partnership to agreements



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to extend the statute of limitations for assessment of tax on partnership items and to settlements with the IRS.³ These obligations create a fiduciary duty on the part of the TMP to the partnership and other partners.⁴ As the Tax Court explained in *Computer Programs Lambda, Ltd. ("Lambda II")*,⁵ the TMP's "initiative during the proceedings as well as the execution of his statutory duties will have a substantial effect upon the rights of all partners in the partnership."

Designation of the TMP

Code Sec. 6321(a)(7)(A) permits a partnership to designate its TMP "as provided in regulations," so long as the person or entity chosen is a general partner in the partnership at the time the designation is made.⁶ A TMP is generally designated at the time the partnership return is filed.⁷ The designation of a TMP remains effective until the revocation or termination of the designation. As will be discussed in more detail below, if the partnership fails to designate a TMP, "the general partner having the largest profits interest in the partnership at the close of the tax year involved" becomes the TMP.⁸ The Secretary of the Treasury may designate a TMP if the partnership has not designated a general partner and it would be "impracticable" to identify the general partner with the largest profits interest.⁹

Resignation, Revocation, and Termination

The TMP may voluntarily resign, or the partnership may want to revoke the TMP's designation. Treasury Regulations provide that a TMP may resign at any time, but in order for the resignation to be effective, the TMP must submit a written statement to the service center with which the partnership return was filed identifying the partnership and TMP by name, address and taxpayer identification number.¹⁰

If the TMP does not agree to resign, the partnership may revoke the designation for any tax year. This can be done at any time after the filing of the partnership return for that tax year by filing a statement with the service center with which the partnership return was filed. This statement must identify by name, address and the taxpayer identification number of the partnership and TMP whose designation is being revoked. The revocation must be signed by general partners who were general partners at the close of the year and shown on the return for that year to hold more

than 50 percent of the aggregate interest in partnership profits held by all general partners as of the close of the tax year.¹¹ If, at the time of revocation, the general partner is dead, has been liquidated or dissolved (if an entity), has been adjudicated by a court of competent jurisdiction as not capable of managing his or her person or estate, or his or her partnership items become nonpartnership items under Code Sec. 6231(b),¹² the revocation must be signed by persons who were partners at the close of the tax year and were shown on the return for that year to hold more than 50 percent of the aggregate interest in partnership profits held by all partners as of the close of such tax year.¹³

There are also circumstances where the TMP is automatically terminated. In addition to death, dissolution and incompetence, if partnership items of the TMP become nonpartnership items under Code Sec. 6231(c) (relating to special enforcement areas), the TMP is automatically terminated.¹⁴ Specifically, Code Sec. 6231(c) authorizes the Treasury to convert partnership items to nonpartnership items where continuing to treat items as partnership items will interfere with the "effective and efficient enforcement" of TEFRA.¹⁵ The same circumstances that cause conversion of a partner's partnership items to nonpartnership items will cause termination of the TMP.

Once the TMP is a debtor in a bankruptcy action, the TMP will no longer be able to serve as TMP for any partnership tax year ending on or before the last day of the latest tax year of the partner with respect to which the United States could file a claim for income tax due in the bankruptcy proceeding.¹⁶ Similarly, if there has been a request for prompt assessment of tax under Code Sec. 6501(d) with respect to a TMP, the TMP designation will be terminated.¹⁷

Another situation where the TMP designation may be terminated is where the TMP is under criminal investigation for the violation of internal revenue laws relating to income tax. A criminal investigation does not automatically trigger the termination; rather, the IRS also must notify the TMP that his or her TMP's partnership items will be treated as nonpartnership items.¹⁸ In *R.K. Phillips*,¹⁹ the Tax Court upheld this regulation and held that the TMP's authority could not be terminated based on the criminal investigation, unless he received written notification from the IRS of the conversion of items to nonpartnership items. Accordingly, a criminal tax investigation of a partner in a TEFRA partnership does not necessarily or immediately interfere with the "effective and efficient

enforcement of the internal revenue laws,” and thus will not automatically cause termination of the TMP.²⁰

Nevertheless, there are circumstances in which the criminal investigation of the TMP will create a disabling conflict of interest that will terminate the TMP designation even where Reg. §301.6231(c)–5 does not apply, *i.e.*, where the IRS has not given notice of the conversion of partnership items. An example of a disabling conflict of interest is found in the Second Circuit’s decision in *Transpac Drilling Venture 1982-12*.²¹ There, the IRS was conducting civil audits of multiple partnerships formed as part of illegitimate tax shelters at the same time that there were ongoing criminal investigations of the partnerships’ promoters and TMPs. The IRS requested extensions of the statutes of limitations for assessment from the TMPs who were cooperating in the criminal investigations of the promoters. The court held that the extensions were invalid because the criminal investigations created in the TMPs “powerful incentive to ingratiate themselves to the government,” and “overwhelming pressure ... to ignore their fiduciary duties to the limited partners.” The court was “especially disquiet[ed]” by the fact that the IRS

knew that the limited partners did not want to grant extensions before it went to the TMPs. In its subsequent decision in *Madison Recycling Associates*,²² the Second Circuit clarified that it would only find that a TMP did not have authority to bind a partnership where the TMP has cause to prefer his or her own interests above his or her fiduciary duties. Accordingly, courts have held that the mere fact that a TMP is under criminal investigation does not create a disabling conflict.²³

Mechanisms for Changing TMPs

If the partnership believes that the TMP should step down and the TMP refuses to resign, the partnership should first look to its own operating agreement to determine the circumstances under which the TMP may resign or may be forced to resign and the method for selecting a new TMP. There are many possible provisions, including identification of an alternate TMP or a requirement that the TMP step down if un-

able to discharge his or her duties for any reason. If the operating agreement is silent on this issue, a vote of the partners may be required to change the TMP.

If the partnership chooses its own successor TMP, the partnership merely needs to notify the IRS of the change in TMP by filing a certification with the service center.²⁴ These rules mirror those for the original designation of the TMP. The partnership also may designate a new TMP for the partnership’s tax year by filing a statement with the service center with the partnership’s identifying information and designate the TMP. This statement must be signed by persons who were general partners at the close of the tax year and were shown on the return for that year to hold more than 50 percent of the aggregate interest in partnership profits held by all general partners as of the close of the year. There is an alternate procedure if the general partner is dead, or if the general partner

is an entity, has been liquidated or dissolved, the general partner is not capable of managing his or her person or estate, or the general partner’s partnership items have become nonpartnership items under Code Sec. 6231(b), where the statement must be signed by persons who were partners at the close

of the tax year and were shown on the return for that year to hold more than 50 percent of the aggregate interest in partnership profits held by all partners as of the close of such tax year.²⁵

If the partnership does not designate a TMP in the first place or the TMP has been terminated and not replaced, unless impracticable, the general partner having the largest profits interest will be the TMP.²⁶ The IRS’s identification of the TMP under the largest profits interest rule is not considered a designation of a TMP by the IRS, and thus the notice requirements described below do not apply.²⁷

If it is impracticable to apply the largest profits interest rule, the IRS may select the new TMP.²⁸ There are three circumstances where it is deemed impracticable to apply the largest profits interest rule: (i) the general partner with the largest profits interest is not apparent from the Schedules K-1 and is not otherwise readily determinable; (ii) each general partner is deemed to have no profits interest in the partnership because of death, adjudication of incompetency, liquidation

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or conversion of partnership items to nonpartnership items; and (iii) the general partner with the largest profits interest is disqualified.²⁹ The general partner is disqualified if he or she (i) has been notified of suspension from practice before the IRS; (ii) is incarcerated; (iii) is resident outside the U.S., its possessions or territories; or (iv) cannot be located or cannot perform the function of a TMP for any reason, except that lack of cooperation with the IRS is not a basis for finding that a partner cannot perform the functions of a TMP.³⁰

The Commissioner's selection of the TMP is governed by certain criteria, including (i) the general knowledge of the partner in tax matters and the administrative operation of the partnership, (ii) the partner's access to the books and records of the partnership, (iii) the profits interest held by the partner, (iv) the view of the partners having a majority interest in the partnership regarding the selection, (v) whether the partner is a partner of the partnership at the time the TMP selection is made, and (vi) whether the partner is a U.S. person.³¹ Before selecting a TMP, the Commissioner will notify the partnership by mail that after 30 days, the Commissioner will make a determination that it is impracticable to apply the largest profits interest rule and will select a TMP unless a designation is made by the partnership.³² The Commissioner's selection of the TMP is a "last resort," and revenue agents should encourage the entity to designate a new qualified TMP.³³ If the Commissioner selects a TMP as described above, the Commissioner will notify the partner selected, the partnership and all partners required to receive notice under Code Sec. 6223(a) of the selection of the TMP within 30 days of the selection.³⁴

The rules described above apply in administrative proceedings. If a judicial proceeding has already been filed, the Tax Court, and not the Commissioner,

appoints a new TMP if one is not designated by the partnership.³⁵ In *Lambda II*, the Tax Court determined that it has inherent authority to appoint a TMP where the designated TMP could no longer serve in order to "assure the fair, efficient, and consistent disposition of partnership litigation pursuant to I.R.C. § 6621, *et seq.*"³⁶ The Tax Court acknowledged that there were procedures in the Treasury Regulations for the IRS to appoint a new TMP, but held that where a partnership is without a TMP before the Tax Court, it is the court who should appoint the TMP to avoid having the partnership's adversary during litigation appoint his own opponent.³⁷

While *Lambda II* was pending, the Tax Court adopted Rule 250 of the Tax Court Rules of Practice and Procedure, which provides that if a partner other than the TMP commences the partnership action and the TMP is not identified in the petition, the court will attempt to establish the identity of the TMP or to appoint a TMP.³⁸ The Tax Court also may remove the TMP for cause if, after notice, the TMP is given the opportunity to be heard. If the TMP is either removed for cause or is otherwise terminated, and the partnership does not designate a successor TMP during the time period directed by the court, the court may appoint another partner as the TMP.³⁹ The incarceration of the TMP and a material breach of fiduciary duty are examples of the circumstances where the Tax Court may remove a TMP for cause.⁴⁰ The Tax Court's removal or appointment of a TMP is for the limited purpose of the pending partnership action.⁴¹ Tax Court Rule 250 contains discretionary language, and indeed, in *Lambda II*, the Tax Court did not hold that it had a *duty* to appoint a TMP, only that it had the inherent power to do so. The Second Circuit, however, has suggested that "where doing so is essential to secure the due process rights of the partners," the Tax Court may have a duty to appoint a TMP.⁴²

If the partnership does not designate a TMP in the first place or the TMP has been terminated and not replaced, unless impracticable, the general partner having the largest profits interest will be the TMP.

ENDNOTES

¹ *Computer Programs Lambda, Ltd.* ("Lambda I"), 89 TC 198, 205, Dec. 44,072 (1987).

² *E.L. Martinez*, DC-LA, 2005-2 USTC ¶ 50,524, *aff'd and rev'd in part*, CA-5, 2009-1 USTC ¶ 50,336, 564 F3d 719, 729.

³ *Id.*; *Lambda I*, 89 TC at 205; Code Sec.

6224(c)(3).

⁴ *E.L. Martinez*, 564 F3d at 728 & n.24; *R.K. Phillips*, 114 TC 115, Dec. 53,769, *aff'd*, CA-9, 2002-1 USTC ¶ 50,103, 272 F3d 1172, 1175 (9th Cir. 2002); *Transpac Drilling Venture 1982-12*, 67 TCM 1995, Dec.

49,628(M), TC Memo. 1994-26, *rev'd and rem'd*, CA-2, 98-2 USTC ¶ 50,517, 147 F3d 221, 225; *Lambda I*, 89 TC at 205.

⁵ *Computer Programs Lambda, Ltd.* ("Lambda II"), 90 TC 1124, 1126, Dec. 44,818 (1988).

⁶ Reg. §301.6231(a)(7)-1(b)(1)(ii); *see also*

ENDNOTES

- Transpac Drilling Venture, 1983-63, 92-2 USTC ¶ 50,486, 26 ClsCt 1245, aff'd, CA-FC, 94-1 USTC ¶ 50,067, 16 F3d 383* (limited partners designated by partnership as TMPs did not qualify as TMPs and could not petition the Tax Court on behalf of the partnership). Unless consent from the Commissioner is obtained, the TMP must be a U.S. person, as defined in Code Sec. 7701(a)(30). Reg. §301.6231(a)(7)-1(a)(2).
- ⁷ Reg. §301.6231(a)(7)-1(c).
- ⁸ Code Sec. 6231(a)(7)(B).
- ⁹ Code Sec. 6231(a)(7).
- ¹⁰ Reg. §301.6231(a)(7)-1(i).
- ¹¹ Reg. §§301.6231(a)(7)-1(j)(1)-(4) and §301.6231(e)(4).
- ¹² Code Sec. 6231(b) provides for treating partnership items as non-partnership items if the Secretary mails to such partner a notice that such items shall be treated as nonpartnership items, the partner files suit under Code Sec. 6228(b) after the Secretary fails to allow an administrative adjustment request, the Secretary or the Attorney General enters into a settlement agreement with the partner with respect to such items, or such change occurs due to the Secretary's failure to provide notice under Code Sec. 6223, or pursuant to Code Sec. 6321(c) (special enforcement areas). Code Sec. 6231(b).
- ¹³ Reg. §§301.6231(a)(7)-1(j)(4), §301.6231(f)(1)(i)-(iv) and §301.6231(f)(2)(iv).
- ¹⁴ Reg. §301.6231(a)(l)(1)-(4). Termination of the designated TMP does not affect the validity of any action taken by that TMP before the termination of the designation. As an example, the Treasury Regulations state that "if a tax matters partner had previously consented to an extension of the period for assessments under Code Sec. 6229(b)(1)(B), that extension remains valid. Reg. §301.6231(a)(7)-1(l)(2).
- ¹⁵ Code Sec. 6231(c)(2).
- ¹⁶ Reg. §301.6231(c)-7.
- ¹⁷ Reg. §301.6231(c)-8.
- ¹⁸ Reg. §301.6231(c)-5.
- ¹⁹ See *R.K. Phillips, supra* note 4.
- ²⁰ *Id.* at 129.
- ²¹ See *Transpac Drilling Venture 1982-12, supra* note 4; see also *Leatherstocking 1983 Partnership, 92 TCM 106, Dec. 56,585(M), rev'd 2008-2 USTC ¶ 50,597, 296 FedAppx 171*, where the TMP was criminally prosecuted and was required under his plea agreement to cooperate fully with the IRS. Although the court found that there was no evidence that the IRS had tried to mislead the limited partners, there was a conflict of interest that invalidated the TMP's consent to extend the statute of limitations for assessment.
- ²² *Madison Recycling Associates, 81 TCM 1496, Dec. 54,300(M), TC Memo. 2001-85, aff'd, CA-2, 2002-2 USTC ¶ 50,515, 295 F3d 280, 289.*
- ²³ See *E.L. Martinez, supra* note 2.
- ²⁴ Reg. §301.6231(a)(7)-1(d).
- ²⁵ Reg. §301.6231(a)(7)-1(f).
- ²⁶ Code Sec. 6231(a)(7)(B); Reg. §301.6231-(a)(7)-1(m)(2).
- ²⁷ IRM 4.31.2.5 (Oct. 1, 2010)
- ²⁸ Code Sec. 6231(a)(7) (flush language); Reg. §301.6231-(m)(2).
- ²⁹ Reg. §301.6231-(a)(7)-1(o)(1)-(3).
- ³⁰ Reg. §301.6231-(a)(7)-1(o)(3).
- ³¹ Reg. §301.6231(a)(7)-1(q)(2).
- ³² Reg. §301.6231(a)(7)-1(r)(2).
- ³³ IRM 4.31.2.5 (Oct. 1, 2010).
- ³⁴ Reg. §301.6231-(r)(1).
- ³⁵ See Tax Court Rule 250; IRM 35.11.1 (July 25, 2012).
- ³⁶ See *Computer Programs Lambda, Ltd. ("Lambda II"), supra* note 5, 90 TC at 1127.
- ³⁷ *Id.* at 1127–28. The Tax Court does not apply this reasoning to administrative proceedings because at that point, there is no certainty of litigation. *Id.* at 1128, n.4.
- ³⁸ Tax Court Rules of Practice and Procedure 250(a).
- ³⁹ *Id.* at 250(b).
- ⁴⁰ See Notes to Rule 250 (1988).
- ⁴¹ *Id.*
- ⁴² *Cinema '84, CA-2, 2005-2 USTC ¶ 50,439, 412 F3d 366, 372.*

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