Tax Controversy Corner

By Megan L. Brackney

Representing the Small Partnership in Tax Controversies

Although representing a small partnership in a tax controversy may seem less complicated than navigating TEFRA,[1] there are many tactical, procedural and ethical issues that must be analyzed to effectively represent the small partnership. Because TEFRA partnerships and non-TEFRA partnerships are each subject to different procedures for audit, assessment and judicial review, the initial question the practitioner must ask is whether TEFRA applies.

The purpose of TEFRA is to "provide a method for uniformly adjusting items of partnership income, loss, deduction or credit that affect each partner."[2] Due to logistical concerns facing the IRS in auditing partnerships with hundreds of individual partners, Congress enacted TEFRA to allow resolution of partnership tax issues in one consolidated partnership-level proceeding rather than multiple partner-level proceedings.[3] TEFRA mandates consistent treatment of all partners and provides procedures under which the IRS and the courts can adjust partnership items in a single, unified partnership proceeding.[4]

In small partnership cases in which TEFRA does not apply, each partner's share of the partnership items is handled individually on the partner's own return. Although not required by statute, the IRS employs various administrative procedures for communicating with partners and linking their cases and the partnership's cases together to avoid inconsistent results between partners.[5]

Before considering the practical issues involved in representing small partnerships, the practitioner must first determine whether the partnership is, in fact, a "small partnership" that is exempt from TEFRA.

Megan L. Brackney is a partner at Kostelanetz & Fink, LLP in New York, New York.

Small Partnerships Exempt from TEFRA

Small partnerships, LLCs and S corporations are not governed by TEFRA.[6] Partnerships and LLCs are excluded from TEFRA if they satisfy the "small partnership" exception and have not elected to be treated as a TEFRA entity.[7] A small partnership includes partnerships and LLCs with 10 or fewer partners or members, each of whom is an individual (other than a nonresident alien), a C corporation or an estate of a deceased partner.[8] For purposes of the exception, foreign corporations and Code Sec. 501(a) tax-exempt organizations are classified as C corporations.[9] A husband and wife (and their estates) are treated as one partner.[10] Also, if there were transfers of partnership interests during the tax year such that there were more than 10 partners for some portion of the tax year, the entity may still be treated as a small partnership.[11]

A partnership that has as a partner, another partnership, trust, S corporation, nominee or other similar disregarded entity does not qualify as a small partnership.[12] Essentially, if any partner during the tax year is a passthrough entity, TEFRA will apply. The determination is made annually, and thus it is possible that a partnership that qualifies as a small partnership in one tax year may be subject to TEFRA in another tax year.

Code Sec. 6231(g) provides a safe harbor for the IRS, such that if the IRS makes a reasonable but mistaken determination as to whether TEFRA applies, the IRS's determination will control.

A small partnership may elect to be included under TEFRA. This election is binding for the year in which it is made and all subsequent years unless revoked with IRS consent.[13] Checking the box on Form 1065 and/or identifying a tax matters partner is not a proper election; the entity must attach Form 8893, or an equivalent statement, to the Form 1065 in the year in which the election is made.[14] This statement must be signed by each person who was a partner at any time during the tax year to which the return relates and filed at the same time and place as the partnership return.[15]

The information contained in the partnership return is determinative of whether the partnership satisfies the small partnership exception.[16] In the context of the former "same-share" test that required all partners of a small partnership to have equal shares of partnership items,[17] courts held that the Commissioner need only look at the partnership return itself to analyze whether a partnership is subject to TEFRA and that neither a partner nor the Commissioner can later "claim a result other than that identified in the return and Schedules K-1 as filed and amended prior to the date of commencement of the partnership audit."[18] This bright-line test prevents the parties from taking a different position after the statute of limitations has run.

As a practical matter, the information on the face of the return controls the classification of an entity as either a small partnership or TEFRA partnership. Code Sec. 6231(g) provides a safe harbor for the IRS, such that if the IRS makes a reasonable but mistaken determination as to whether TEFRA applies, the IRS's determination will control. The IRS's determination is reasonable if it is consistent with the information that the taxpayer reported on its return. For example, in *S.C. Cole*[19] the taxpayer argued that TEFRA applied to it, and the IRS had improperly failed to issue a final partnership administrative adjustment ("FPAA")[20] for partnership items. The partnership, however, had stated on its return that it was not subject to TEFRA, and thus the Tax Court found that the IRS had reasonably determined that TEFRA did not apply and that the application of Code Sec. 6231(g) approved the small partnership treatment.[21]

A recent illustration of the dangers of not correctly ascertaining whether TEFRA applies is the case of *S.F. Brennan*.[22] In *S.F. Brennan*, the issue was whether the Tax Court had jurisdiction over the individual partner's claim that certain guaranteed payments of a partnership entitled the partner to flow-through losses. The taxpayer partners, a married couple, indirectly owned a partnership, Cutler & Company, LLC ("Cutler"). The taxpayers originally owned Cutler directly, but later organized another partnership, Airport Plaza, to hold their interest in Cutler. On its Form 1065, Airport Plaza reported losses for guaranteed payments, which the taxpayers then deducted on their individual returns. The IRS disallowed the losses, and the taxpayers filed a petition in the Tax Court. After it was discovered that Airport Plaza had not made the guaranteed payment, the taxpayers filed an amended petition alleging that the guaranteed payments were actually made by Cutler, not Airport Plaza. The Commissioner argued that the Tax Court did not have jurisdiction to consider the taxpayers' claim that they are entitled to a flow-through deduction from Cutler because Cutler was subject to TEFRA and the guaranteed payments were partnership items that could only be determined in a partnership-level proceeding. The issue turned on whether Cutler qualified for the small partnership exception. Because the taxpayers had transferred their membership interest to Airport Plaza, a general partnership, the Tax Court held that Cutler did not qualify for the small partnership exception.

The taxpayers attempted to disavow the formation and substance of Airport Plaza, but the Tax Court held that the taxpayers were bound to the business form they chose: "to allow [the taxpayer] to challenge her chosen form and assert the priority of what she subsequently claims is the actual substance would only involve this Court in the [taxpayers'] post-transactional planning and undermine legitimate tax policy objectives. We decline that invitation." The Tax Court thus held that the taxpayers were bound by their election to treat Airport Plaza as a passthrough partner of Cutler and that Cutler did not qualify for the small partnership exception. Accordingly, the Tax Court lacked jurisdiction to review the claims regarding the deduction of the guaranteed payments.[23] Although *S.F. Brennan* presents a unique set of facts, it illustrates an unintended outcome that could occur if partners are not aware of the TEFRA status of their partnership or the consequences of that status.

Procedures for Tax Assessments and Judicial Review of Small Partnerships

After determining that the partnership is, indeed, a "small partnership," the practitioner should keep a close eye on the statute of limitations for assessment during the audit. The applicable statute of limitations is that of each individual partner under Code Sec. 6501.[24] Accordingly, the IRS must secure statute extensions from each partner in order to make adjustments to that partner's return. Securing a Form 872 from one partner will not extend the statute of limitations for other partners. Moreover, all adjustments for both partnership and nonpartnership items are made to all the partners' returns simultaneously.[25] Unlike TEFRA examinations, the IRS must issue a statutory notice of deficiency pursuant to Code Sec. 6212, and that notice must contain all adjustments—both at the partnership and partner levels.

As noted above, TEFRA was enacted to provide uniformity in treatment of investors in large partnerships and other passthrough entities. Consequently, TEFRA requires the IRS to offer the same settlement agreement to any partner who requests it.[26] There is no similar requirement for adjustments to small partnership returns. Rather, the tax liabilities for partners of a non-TEFRA entity are determined on an individual basis,[27] and thus, the IRS cannot enter into a settlement with the partnership that will bind the individual partners. This means that there can be inconsistent results among the partners after audit. For example, one partner may reach a settlement agreement with the IRS, and another partner may challenge the items and achieve a different result in Tax Court or after a refund action.

If a settlement is not reached, IRS Appeals has jurisdiction over non-TEFRA cases and will consider both partnership and partner-level adjustments.[28] Any investor may submit a protest, although, generally, only one protesting investor will be sent to Appeals unless protesting investors have different representatives, one or more investors is not represented or there are un-agreed nonpassthrough issues.[29] While the passthrough items are at Appeals, the other partners' returns are held in suspense, even those of partners who did not respond to the 30-day letter.[30]

If the case is not resolved and the IRS does issue notices of deficiencies, the general time period for petitioning the Tax Court applies: 90 days, or 150 days if the notice is addressed to a person outside of the United States, after the notices are mailed.[31] Under TEFRA, the tax matters partner must file the petition within 90 days after an FPAA is mailed, but if the tax matters partner does not petition, the "notice partners," or five-percent group,[32] may petition within 60 days after the original 90-day period expires.[33] Because different time periods apply to petition the Tax Court, it is crucial for the practitioner to pay attention to whether the partnership is a small partnership or a TEFRA partnership in each affected tax year and whether the items at issue are partnership or nonpartnership items. A mistake on these points could lead to a lost opportunity for Tax Court review.

For example, in *B.S. Dhillon*,[34] the IRS issued a notice of deficiency to the taxpayer partnership, but the individual partners did not file their Tax

Court petitions within 90 days. The taxpayers attempted to avoid dismissal by arguing that the extended filing period for TEFRA notice partners applied, therefore making the petition timely. The Tax Court, however, dismissed the petition because the partnership, which was owned by a husband and wife, was a small partnership and thus TEFRA did not apply to it.

Ethical Considerations in Dual Representation of the Partnership and Its Partners

In representing a small partnership, it is often difficult to delineate between representation of the individual partners and the partnership itself. Small partnerships may generate this ambiguity because the interests of the partners are often "personal and co-extensive."[35] The attorney should pay careful attention to the identity of his or her client and be vigilant for issues of conflicts of interest, attorney-client privilege and confidentiality.

The attorney-client relationship does not automatically arise between the individual partners and the attorney for the partnership: "something more is required to create an attorney-client relationship with a partner."

Generally, a lawyer who represents a partnership represents the entity rather than the individual partners.[36] The attorney-client relationship does not automatically arise between the individual partners and the attorney for the partnership: "something more is required to create an attorney-client relationship with a partner."[37] The attorney and the individual partner may affirmatively form an attorney-client relationship, or it may be implied based on the specific facts and circumstances. Relevant factors include the type and size of the partnership and the relationship between the partners. An attorney-client relationship is more likely to arise with the individual partners of a two-person general partnership than with the partners of a partnership with dozens of limited partners.[38] Other relevant considerations include: the nature and scope of the attorney's engagement by the partnership, the type and extent of contacts between the attorney and the individual partner, the attorney's access to information relating to the individual partner, whether the individual partner had been separately represented by other counsel and whether any fees were paid by the partner or with respect to any services performed for the partner.[39]

In order to avoid unintentionally forming an attorney-client relationship with a partner, or misleading a partner into believing such a relationship exists, the attorney retained by a partnership should explain his or her role as counsel to the partnership and not the individual partners, and then, if asked to represent an individual partner, seek informed consent from the partnership and all of the individual partners.[40]

In addition, before affirmatively undertaking to represent an individual partner and the partnership, the attorney should consider whether he or she will be able to discharge his or her duties to both clients. ABA Model Rule of Professional Conduct Rule 1.7(a) prohibits an attorney from representing the interests of one partner against another partner in a matter involving the partnership affairs without first obtaining informed consent from all parties. Whether the attorney is barred from the representation will depend on the potential compromises to the attorney's duties of fidelity, candor and independent professional judgment either to the partnership or to the individual partners, and whether dual representation would impede the attorney's ability to maintain the confidentiality of communications.[41]

One ethical issue that arises when representing both the individual partners and the partnership is the conflict of interest. ABA Model Rules of Professional Conduct 1.7 provides that a conflict of interest exists if the representation of one client is directly adverse to another client or there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client. Circular 230 contains a similar rule,[42] and both the Model Rules and Circular 230 allow a client to waive the conflict of interest and give informed consent. The practitioner, however, must reasonably believe that he or she will be able to provide competent and diligent representation to each affected client.[43]

A related issue is whether the attorney representing both the partnership and the partners can discharge his or her duties to the partnership under Model Rule 1.13(b), which provides that if a lawyer for a partnership knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a manner that violates a legal obligation of the organization or that is likely to result in substantial injury to the organization, the attorney must act in the best interest of the organization. An attorney who has undertaken to represent an individual partner and the partnership may not be able to discharge this duty if the client partner has taken or is contemplating taking an action adverse to the partnership.[44]

Attorney-client privilege and confidentiality issues can also become a thicket where the attorney represents both the partnership and one or more of its partners. ABA Model Rule 1.6(a) provides the general rule that a lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent or as is necessary to carry out the representation. With dual representation of a partnership and its individual partner or partners, there are also at least two questions of confidentiality: (i) under what circumstances does information received by the partnership's lawyer from an individual partner constitute "information relating to representation" of the partnership so as to give the partnership a right of access to that information; and (ii) "to what extent is each partner entitled to know whatever information has been conveyed on the partnership's behalf to the partnership's lawyer?"[45]

Two approaches have developed in the context of attorney-client confidentiality when representing partnerships. First, California courts have focused on the fiduciary relationship between partners. In *McCain v. Phoenix Resources, Inc.*,[46] a limited partner filed suit after the attorneys for the general partner refused release of information on the ground of attorney-client privilege between themselves and the partnership. The Court of Appeals held that the limited partners had a right of access to the partnership information because all partners are trustees for one another and have a fiduciary duty to disclose information to each other and that "the attorney-client privilege will not bar disclosure of matters related to a partnership business simply because such business was conducted through a law firm." The court noted, however, that if a partner communicated private or personal information to the partnership's attorneys, the attorney-client privilege would prevent the attorney from disclosing that information to other partners.[47]

The ABA Committee on Ethics and Professional Responsibility reached the same result, although its position is based on an entity view of the partnership, *i.e.,* that the partnership has distinct rights and duties apart from its constituents. Under this view, "information received by a lawyer representing the partnership is 'information relating to the representation' of the partnership, and normally may not be withheld from individual partners."[48] This includes information provided by individual partners to the attorney representing the partnership.

ENDNOTES

1 As part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Code Secs. 6221 through 6233 were amended to provide unified proceedings for certain partnerships.

2 *R.L. Harrell*, 91 TC 242, Dec. 44,990 (1988).

3 Staff of Joint Comm. on Taxation, 97th Cong., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982.

4 *See* Code Secs. 6221–6233.

5 *See* IRM 4.31.5.8; IRM 4.31.5.9; *see also* Stephen R. Mather, *et al.*, AUDIT PROCEDURES FOR PASS-THROUGH ENTITIES (2009) ("While the TEFRA partnership audit procedures present a significant departure from the previous procedures for auditing partnership adjustments, there is a substantial degree of similarity in the steps for both non-TEFRA and TEFRA audits.").

6 Reg. §301.6231(a)(1)–(a)(3).

7 Code Sec. 6231(a)(1)(B).

8 *Id.*; Reg. §301.6231(a)(1)-1(a)(1).

9 Rev. Rul. 2003-69, 2003-1 CB 1118.

10 Code Sec. 6231(a)(12). Divorce can impact the small partnership status since it results in two partners instead of one for purposes of the 10-partner limit.

11 Reg. §301.6231(a)(1)-(a)(1).

12 *See* Reg. §301.6231(a)(1)-(a)(2) (small partnership exception does not apply if any partner is a pass-through partner as defined in Code Sec. 6231(a)(9) other than an estate); Rev. Rul. 2004-88, 2004-2 CB 165. In addition, S corporations whose tax period begins after December 31, 1996, are not subject to TEFRA. Act Sec. 1307(c)(1) of the Small Business Job Protection Act of 1996§ (P.L. 104-188), 104th Cong., 2d. Sess.

13 Reg. §301.6231(a)(1)-(b)(3).

14 Code Sec. 6231(a)(1)(B); IRM 4.31.5.5.

15 *See L.J. Wadsworth*, 93 TCM 940, Dec. 56,849(M), TC Memo. 2007-46 (partnership that did not file an election statement, checked box "no" indicating that it is not subject to TEFRA while at the same time inserting partner's name as tax matters partner, "exhibit[ed] more of an intent to fall outside the TEFRA procedures than an intent to positively elect into them.").

16 Code Sec. 6231(g); *S.C. Cole*, CA-7, 2011-1 USTC ¶50,301, 637 F3d 767.

17 *See* Reg. §301.6231(a)(1)-1T(a)(3) (1987). The same share test was repealed by Act Sec. 6255 of the Taxpayer Relief Act of 1997§ (P.L. 105-34), 105 Congress, 1st Sess., and no longer applies for tax years ending after August 5, 1997.

18 *Z-Tron Computer Research and Development Program*, 91 TC 258, Dec. 44,991 (1988); *R.L. Harrell*, 91 TC 242, Dec. 44,990 (1988).

19 *S.C. Cole*, 99 TCM 1132, Dec. 58,137, TC Memo. 2010-31, *aff'd* CA-7, 2011-1 USTC ¶50,301, 637 F3d 767.

20 In TEFRA proceedings, in order to assess tax on partnership items, the IRS must first issue a final partnership administrative adjustment ("FPAA"). Code Sec. 6223(a)(2).

21 Similarly, in *M. Buchsbaum*, 83 TCM 1777,

ENDNOTES

Dec. 54,769(M), TC Memo. 2002-138, the taxpayer partner alleged in his Tax Court petition that the partnership was a small partnership in order to establish jurisdiction over whether he incurred a loss from the partnership.

The partnership had checked the box stating that it was not subject to TEFRA, but because Schedules K-1 were issued to two trusts, the Tax Court found that the partnership was not a small partnership.

[22] *S.F. Brennan*, 104 TCM 18, Dec. 59,110(M), TC Memo. 2012-187.

[23] The impact of this decision is that both parties are bound by Cutler's treatment of the guaranteed payments because the statute of limitations for the IRS to adjust Cutler's partnership items and the time for the taxpayers to seek an administrative adjustment had expired. Code Sec. 6227(a)(1) provides that a TEFRA partnership may file a request for an administrative adjustment of partnership items within specified periods or before the IRS issues an FPAA with respect to such taxable year. This request is made by filing Form 8082.

[24] In *S.B. Bufferd*, SCt, 93-1 USTC ¶50,038, 506 US 123, 113 SCt 827, the Supreme Court held that an open return of an S corporation shareholder could be adjusted even though the statute of limitations had run on the S corporation's return. Later, in *T.E. Charlton*, CA-9, 93-1 USTC ¶50,239, 990 F2d 1161., the Ninth Circuit reached the same conclusion for non-TEFRA partnerships.

[25] IRM 4.21.5.12.1.

[26] Code Sec. 6224(c)(2).

[27] If it cannot reach an agreement with a partner, the IRS will issue a notice of deficiency to that partner individually. *See* ECC 201107015 (Jan. 3, 2011).

[28] IRM 8.19.9.1; IRM 8.19.9.1.3.

[29] IRM 8.19.9.4.1.4.1.

[30] IRM 8.19.9.4.1.4.2.

[31] Code Sec. 6213(a).

[32] Code Sec. 6226(b)(1).

[33] Code Sec. 6226(a) & (b).

[34] *B.S. Dhillon*, 78 TCM 1, Dec. 53,437(M), TC Memo. 1999-214.

[35] ABA Committee on Ethics and Professional Responsibility, ABA Formal Opinion 91-361 ("Op. 91-361").

[36] ABA Model Rules 1.13(a) ("a lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.").

[37] *Responsible Citizens v. Superior Court*, 16 Cal. App. 4th 1717, 1731 (1993).

[38] *See, e.g., Woods v. Superior Court*, 149 Cal. App. 3d 931 (1983) (holding that attorney who represented closely held corporation owned by wife and husband should be disqualified from representing husband in divorce).

[39] *Responsible Citizens v. Superior Court*, 16 Cal. App. 4th 1717, 1733 (1993); ABA Op. 91-361; see also *United States v. Daugerdas*, 757 FSupp2d 364, 373 (S.D.N.Y. 2010) (finding that partner failed to establish that he sought advice concerning his potential criminal liability in a personal capacity, and thus may not assert attorney-client privilege over communications with partnership's attorneys); *Mursau Corp.* v. *Florida Penn Oil & Gas*, 638 F. Supp. 259, 263 (W.D. Pa. 1986) (no attorney-client relationship formed where limited partner had independent legal counsel, paid no fees to partnership, and legal fees related to partnership services, except for advice to limited partner on tax consequences which was "paid for by the partnership as part of its efforts to secure a limited partner for its venture.").

[40] ABA Op. 91-361; *see also e.g., Griva* v. *Davison*, 637 A.2d 830 (D.C. 1994) (emphasizing the importance of informed consent if a law firm intends to represent both the partnership and the individual partners).

[41] *See, e.g.*, Griva, 637 A.2d 830 at 844 ("a law firm ethically can represent several individuals in creating a partnership after obtaining their informed consent" ... "except when such dual or multiple representation would result in an 'actual conflict of positions ...'.").

[42] 31 CFR §10.27.

[43] 31 CFR §10.27(b)(1); Model Rule 1.7(b)(1).

[44] ABA Op. 91-361.

[45] *Id.*

[46] 185 Cal. App. 3d 575 (1986).

[47] *See also Wortham and Van Liew v. Superior Court (Clubb)*, 188 Cal. App. 3d 927 (1987) (compelling attorney for partnership to testify in proceeding by partner to dissolve partnership under California's Joint Client Rule of Evidence, which provides that "the attorney must divulge all partnership information to all partners.").

[48] ABA Op. 91-361.