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Ninth Circuit: Disregarded entities can be pass-thru partners, under TEFRA audit procedures

The U.S. Court of Appeals for the Ninth Circuit today affirmed the U.S. Tax Court's dismissal of a petition challenging a notice of Final Partnership Administrative Adjustment (FPAA) for lack of jurisdiction.

At issue was whether entities that are disregarded for federal tax purposes can be pass-thru partners so that the partnership is not eligible for the small-partnership exception under section 6231. The Ninth Circuit concluded that an entity's disregarded status does not preclude its classification as a pass-thru partner.

The case is: *Seaview Trading LLC v. Commissioner*, No. 15-71330 (9th Cir. June 7, 2017). Read the Ninth Circuit's [decision](#) [PDF 199 KB]

Summary

An individual (K) and his father formed a limited liability company (LLC) that was, under the federal tax regulations, treated as a partnership. The LLC acquired an interest in a common trust fund which reported a loss that was allocated to its investors, including the LLC. After an audit, the IRS issued a FPAA disallowing the loss from the LLC's trust investment and imposed penalties.

K contended that the LLC was a "small partnership" not subject to the TEFRA audit procedures.

The Ninth Circuit, however, held that entities that are disregarded for federal tax purposes may nevertheless constitute pass-thru partners under section 6231(a)(9); that the small-partnership exception under section 6231 does not apply; and that the partnership is therefore subject to the TEFRA audit procedures.

The Ninth Circuit also determined that resolution of the issue was "inextricably intertwined" with K's contention that he had standing to file a petition for readjustment

of partnership items on behalf of his purported small partnership. The Ninth Circuit held that, because a party (K), other than the LLC's tax matters partner, filed a petition for readjustment of partnership items after the partnership had timely filed for the same, the Tax Court lacked jurisdiction under section 6226. The Ninth Circuit affirmed the Tax Court's dismissal of K's petition for lack of jurisdiction.

KPMG observation

Under the *Bipartisan Budget Act of 2015*, the TEFRA provisions are repealed for tax years beginning in 2018 and are replaced by new rules for partnership audits, which allow assessment and collection of income tax at the partnership level.

The new partnership audit rules allow for the partnership to elect out of the new provisions if the partnership has 100 or fewer partners for the year and has only eligible partners that are individuals, C corporations, foreign corporations that that would be treated as C corporations if they were domestic, S corporations, and estates of deceased partners.

It appears that a partnership that has a disregarded entity—one that is owned entirely by a C corporation or an individual—as a partner will not be allowed to elect out of the new provisions. Accordingly, if the partnership intends to elect out of the new provisions because it does not have more than 100 partners, it may want to determine that any partnership interest is owned directly by one of the specifically enumerated eligible partners, rather than through a disregarded entity.

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