TaxNewsFlash

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U.S. Tax Court: Period of limitations for assessing tax on partnership items expired

The U.S. Tax Court last week released a memorandum opinion holding that the period of limitations for assessing tax attributable to TEFRA partnership items had expired with respect to an individual indirect partner of the partnership.

The case is: *American Milling, LP v. Commissioner,* T.C. Memo 2023-83 (June 29, 2023). Read the Tax Court's opinion [PDF 140 KB]

Summary

The Tax Court's opinion summarized the facts as follows. The taxpayer engaged in a series of transactions constituting a Son-of-BOSS tax shelter in 1998. Multiple entities were formed to facilitate the tax shelter, including an upper-tier partnership (UTP) in which the taxpayer was an indirect partner, and a lower-tier partnership (LTP) in which the UTP was the tax partners partner. The IRS in 2006 issued to UTP, as the tax matters partner of LTP, a final partnership administrative adjustment (FPAA) with respect to LTP's 1998 Form 1065 ("LTP FPAA"). In the LTP FPAA, the IRS determined, among other things, that LTP was a sham partnership and the Son-of-BOSS transactions lacked economic substance and correspondingly made adjustments to LTP's ordinary income, capital contributions, portfolio income, and investment income. UTP (as TMP of LTP) contested the LTP FPAA adjustments in the U.S. District Court for the Southern District of Illinois, which upheld the IRS adjustments, other than with respect to the accuracy-related penalty.

The IRS in 2013 issued to the tax matters partner of UTP (the petitioner in this case) a FPAA with respect to UTP's 2000, 2001, 2002, and 2003 Forms 1065 ("UTP FPAA"). The IRS determined that UTP (1) claimed inflated depreciation deductions for 2000 through 2003, (2) claimed an inflated capital loss for 2002, and (3) erroneously claimed a deduction of $300,000 for 2000 for legal fees incurred in connection with the tax shelter. The petitioner did not dispute the correctness of any of those adjustments, but challenged the IRS' adjustments in the Tax Court on the grounds that the UTP FPAA

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was a “reproduction” of the LTP FPAA and violated the rule prohibiting the IRS from issuing a second FPAA under section 6223(f). Alternatively, the petitioner contended that all adjustments in the UTP FPAA were computational adjustments flowing from the LTP FPAA and there were no affected items requiring determinations at the UTP level and that the IRS did not have authority to issue the UTP FPAA because neither the Code nor the regulations authorized the issuance of an affected items FPAA.

In an earlier opinion, the Tax Court rejected the petitioner’s arguments, holding that the UTP FPAA was not a duplicate of the LTP FPAA since it was issued to a different partnership, for different tax years, and made materially different adjustments to items of income and expense. In addition, the court concluded that the adjustments in the UTP FPAA (i.e., the adjustments to depreciation, capital loss, and legal fees deductions) were adjustments to the partnership items of UTP.

The petitioner also challenged the adjustments in the UTP FPAA to the extent such adjustments may result in assessment of tax against the taxpayer, an indirect partner of UTP, on the ground that the period of limitations for assessing tax attributable to UTP’s partnership items had expired with respect to the taxpayer at the time the UTP FPAA was issued to the petitioner.

The Tax Court summarized the applicable law as follows:

- The Code prescribes no stand-alone deadline for issuing an FPAA. If an FPAA is issued after the time for assessing tax against the individual partner has expired, it will be of no avail because any assessment attributable to partnership items in the FPAA will be barred with respect to that partner.
- Under section 6501(a), the IRS is required to assess tax or send a notice of deficiency to a taxpayer within three years after a federal tax return is filed. In the case of a tax imposed on partnership (and affected) items, however, section 6229 sets forth special rules that can extend the period of limitations prescribed by section 6501.
- Section 6229(a) prescribes a minimum three-year limitations period, commencing on the later of the date on which the partnership return is filed or the last day for filing such a return, without regard to extensions, for the assessment of tax attributable to any partnership item or affected item.
- Under section 6229(d), the timely mailing of an FPAA suspends the running of the limitations period for assessing any income tax that is attributable to any partnership item or affected item. The limitations period remains suspended for the period during which an action may be filed in court, during the pendency of any proceeding actually brought, and for one year thereafter.
- If a partner is an unidentified partner, then section 6229(e) holds open that partner’s period of limitations with respect to partnership items (or affected items) until at least one year after that partner is properly identified.

None of the Forms 1065 filed by UTP or LTP listed the taxpayer as a direct or indirect partner. The IRS thus argued that section 6229(e) kept the limitations period open with respect to the taxpayer. Specifically, the IRS reasoned that because the items adjusted in the UTP FPAA were both partnership items of UTP and affected items of UTP (affected by the LTP items), then the LTP FPAA is the FPAA that counts for determining the period of limitations. Because the LTP FPAA was issued within the period prescribed by section 6229(e)(2)(A), and the taxpayer was an undisclosed partner of LTP, the IRS argued the period to assess against the taxpayer the tax attributable to the partnership items in the UTP FPAA was open at the time the UTP FPAA was issued.

The parties did not dispute that the taxpayer was an unidentified partner. The parties also did not dispute that the LTP FPAA was issued with the prescribed limitations period, and the UTP FPAA was not. The issue before the Tax Court was whether the UTP FPAA items could be treated as affected items of UTP (affected by the LTP items) with respect to which the LTP FPAA was timely issued under section 6229(e).

The Tax Court rejected the IRS argument, finding that the same items cannot be both partnership items and affected items with respect to the same entity. The court earlier held that the adjustments in the UTP FPAA were partnership items of UTP, not merely affected items flowing from LTP through UTP and ultimately to the taxpayer. The court held the IRS could not now argue that those same items were

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also affected items of UTP (affected by the LTP items) for purposes of applying section 6229(e). The court stated that the IRS effectively was asking it "to ignore an FPAA of a pass-through partnership when determining whether an FPAA issued to that pass-through partnership was issued within the prescribed limitations period," for which there was no statutory basis. The court then concluded that because the UTP FPAA was not timely under section 6229(e)(2)(A), that section did not hold open the period of limitations for assessment against the taxpayer.

The court similarly rejected the IRS' argument that the period of limitations was extended with respect to the taxpayer under section 6229(e)(2)(B) because the taxpayer reported items on his individual tax return inconsistently with how those items were reported on the LTP partnership return and failed to notify the IRS about the inconsistent treatment. The court held that because the taxpayer did not file inconsistently from UTP, section 6229(e)(2)(B) did not keep the period of limitations open with respect to the taxpayer when the UTP FPAA was issued.

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