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SN Worthington: Electing Into the Centralized Partnership Audit Regime

by Gregory T. Armstrong

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In this post, Armstrong discusses a Tax Court case that addressed for the first time the application of the Bipartisan Budget Act centralized partnership audit regime to a partnership that elected to be subject to that regime early.

As the IRS continues to ramp up its enforcement efforts against partnerships, more and more partnerships will enter the tax procedure thicket that is known as the centralized partnership audit regime (CPAR). Enacted almost 10 years ago as part of the Bipartisan Budget Act of 2015, CPAR (also known as the BBA rules) empowers the IRS to pursue the partnership itself for any tax resulting from an adjustment to the partnership return, rather than seeking out and collecting tax from each of the partnership's partners. Although CPAR governs partnership returns filed for the past handful of tax years, we have yet to see a court weigh in on the thorny application of the BBA rules. That is, until now.

On May 22, 2024, in a case of first impression, the Tax Court held that the IRS should have followed the BBA procedures in conducting an exam of the partnership's 2016 tax year. *SN Worthington Holdings LLC v. Commissioner*, 162 T.C. No. 10 (2024). Because the IRS incorrectly applied the 1982 Tax Equity and Fiscal Responsibility Act procedures to that exam, the Tax Court found the notice of final partnership administrative adjustment (FPAA) issued by the IRS was invalid and ordered the case dismissed for lack of jurisdiction. At the heart of the dispute was the partnership's ability, or lack thereof, to pay a potential partnership-level liability determined under the BBA.

This post and a second part summarize the facts that led to the dispute between the IRS and the partnership, discuss the Tax Court's holdings, and offer some observations on the opinion, including how the court's opinion fits within the BBA context more broadly.

Background

In 2018, the IRS selected SN Worthington Holdings LLC's 2016 partnership return for examination. As 2016 was a tax year prior to the effective date of CPAR, the exam was initially subject to the TEFRA audit procedures. As part of notifying SN Worthington that its 2016 return was selected for audit, the IRS asked whether the partnership, in lieu of proceeding under the TEFRA procedures, wanted to elect to have the BBA rules apply instead. Under an off-code provision enacted as part of the BBA, partnerships can elect into CPAR for a tax period beginning after November 2, 2015 (the date of the BBA's enactment) and before January 1, 2018 (the BBA's effective date).

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SN Worthington decided to make this election and filed a Form 7036, "Election under Section 1101(g)(4) of the Bipartisan Budget Act of 2015," with the IRS. Form 7036 generally requires the partnership to provide identifying information, to designate a partnership representative for the tax year under audit, and to attest to a series of factual representations as required by reg. section 301.9100-22. One such representation requires the partnership to attest that it "has sufficient assets, and reasonably anticipates having sufficient assets, to pay the potential imputed underpayment that may be determined during the partnership examination." See reg. section 301.9100-22(2)(ii)(E). It was this representation that led to a dispute between SN Worthington and the IRS regarding the validity of the partnership's election to have the BBA apply.

The IRS responded to SN Worthington's Form 7036 by sending a letter in which it questioned the partnership's ability to pay a potential BBA liability. The letter indicated that after reviewing the 2016 return, it appeared to the IRS that SN Worthington could not satisfy its representation that it had sufficient assets to pay an "imputed underpayment," that is, the partnership-level liability determined under the BBA. The letter offered SN Worthington the chance to provide documentation to refute the IRS's determination. SN Worthington did not reply, and the IRS issued a second letter invalidating the election into CPAR on the ground SN Worthington failed to provide "proof of sufficient available assets" to pay an imputed underpayment. (The letter also determined that the election was not signed by the appropriate person as required by the regulations, but the court found this issue was not in dispute after the IRS failed to pursue this argument before the court.)

Having decided the election into CPAR was invalid, the IRS continued the exam under the TEFRA procedures and issued a TEFRA FPAA redetermining partnership items for the 2016 tax year. SN Worthington filed a petition to challenge the TEFRA FPAA and moved to dismiss the case on the ground the TEFRA FPAA was invalid because the partnership elected to have the BBA rules apply to the 2016 exam.

The Tax Court Sides With SN Worthington

The Tax Court held for SN Worthington and determined the partnership's election into CPAR was valid because it met the requirements of reg. section 301.9100-22. The court began its analysis by stating:

> Taxpayers make valid elections when they comply with the plain text of the election requirements. The manner for making an election can be set forth in various ways, including by statute or Treasury regulation. But once it is established, the Commissioner may not add ad hoc additional requirements.

The court walks through a series of cases in which the IRS was precluded from imposing more stringent requirements than those set forth in the provision authorizing the election. For example, courts have upheld elections made or perfected on amended returns, despite the IRS arguing that the election had to be made on an original return, because the election provision did not impose an original return requirement. See, for example, *Roy H. Park Broadcasting Inc. v. Commissioner*, 78 T.C. 1093 (1982); *Estate of McAlpine v. Commissioner*, 96 T.C. 134 (1991). In contrast, the court also highlights cases where taxpayers have failed to meet the essential requirements of the election and therefore had their elections invalidated. For example, courts have found elections insufficient where the taxpayer failed to attach the election to a timely filed return or failed to include the required signatures. See, for example, *Estate of Woodbury v. Commissioner*, T.C. Memo. 2014-66; *Greenberg v. Commissioner*, T.C. Memo. 2018-74.

Here, the Tax Court concluded that SN Worthington timely filed the Form 7036 and complied with the specific requirement that it represent it had sufficient assets to pay an imputed underpayment. The IRS maintained that for an election into BBA to be valid, the partnership not only must represent it has sufficient assets, but also must establish it has those assets to satisfy a potential imputed underpayment liability. As support for this position, it pointed to reg. section 301.9100-22(a), which provides: "An election is not valid if it frustrates the purposes of section 1101 of the BBA." In effect, the IRS argued that having

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sufficient assets to cover a BBA liability was a requirement for making a valid election into CPAR; to permit otherwise, in the IRS's view, would frustrate the purpose of the BBA regime itself.

Ultimately, the court rejected the IRS's argument, finding that the regulation did not impose a requirement to have sufficient assets, only a requirement to represent that the partnership had sufficient assets. "When there is doubt to the meaning of a regulation, we interpret the regulation against the drafter," and presume the regulation writer "said what it means and means what it said," wrote the court. See slip opinion (citing *Sklar, Greenstein & Scheer P.C. v. Commissioner*, 113 T.C. 135, 143 (1999) (internal quotations omitted)). The court concluded:

> The Commissioner could have required partnerships to establish that they have enough assets to pay an imputed underpayment. But that is not what the Commissioner has written. Instead, he requires the partnership to make a representation that it has enough assets to pay an imputed underpayment, which is what SN Worthington has represented.

The court also ruled against the IRS on its equitable estoppel argument. The IRS argued that SN Worthington was equitably estopped from arguing the BBA applied "based on its misleading silence and later statements regarding the applicability of TEFRA, to which respondent relied upon to his detriment." Although the Tax Court agreed SN Worthington's silence had misled the IRS, the court determined that the IRS still possessed all the facts it needed to determine the validity of the partnership's election. Thus, the court found the IRS could not establish all the elements necessary for a finding of equitable estoppel.

In part two of this post, I will discuss some additional lessons of the case. ■

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