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## JUMPING THE SHARK: THE CASE FOR REPEALING THE TEFRA PARTNERSHIP AUDIT RULES

by

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### ABSTRACT

*By their very nature, partnerships present problems for the U.S. tax system. Are they separate entities or just aggregates of their partners? It depends on the situation. Prior to 1982, the Internal Revenue Service had little choice but to audit the tax consequences of partnership activities by auditing each partner. Congress flipped that aggregate treatment on its head by enacting entity-focused partnership audit rules in the Tax Equity and Fiscal Responsibility Act of 1982. It's time to flip them back.*

*Neither the practical problems that drove creation of the entity-focused partnership audit rules nor the tax policy rationales used to justify them retain strength today. Indeed, almost thirty years of experience with those rules has unearthed numerous negative consequences. Furthermore, improvements in the substantive law applicable to partnerships and in the technology available to the Internal Revenue Service for use in auditing partnerships have significantly reduced the benefits derived from the current partnership audit rules. In short, their costs now outweigh their benefits and they should be repealed.*

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<b>I. INTRODUCTION</b> .....	505
<b>II. THE TEFRA PARTNERSHIP AUDIT RULES</b> .....	506
A. <i>The Practical Problem That Spawned Them</i> .....	507
B. <i>Policy Justifications</i> .....	511
C. <i>Operational Basics</i> .....	512
<b>III. THE CASE FOR REPEAL</b> .....	518
A. <i>Effectiveness in Accomplishing Goals</i> .....	518
1. <i>Simplification/Administrability</i> .....	519
a. <i>Procedural Simplicity: Streamlining's</i> <i>Benefits and Costs</i> .....	522
b. <i>Rules Simplicity: A Heavy Toll</i> .....	531
2. <i>Fairness Concerns</i> .....	538
a. <i>Fairness to the Partners</i> .....	539
b. <i>Fairness Among the Partners</i> .....	547
3. <i>Economic Efficiency</i> .....	552
B. <i>TEFRA's Practical Shortcomings</i> .....	555
1. <i>The Rules' Limited Reach</i> .....	555
2. <i>Changing Circumstances</i> .....	560
<b>IV. CONCLUSION</b> .....	564

## I. INTRODUCTION

Disco, bellbottoms, Swedish super group ABBA, and *Star Wars* were all the rage in 1978 when the Treasury Department and the Internal Revenue Service (IRS) first began seriously agitating for fundamental changes in the procedures used to review the tax consequences of partnerships' economic activities.<sup>1</sup> Disco, bellbottoms, and ABBA were already passé by the time Treasury and the IRS succeeded in convincing Congress to act in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").<sup>2</sup> Even *Star Wars* eventually outlived its appeal.<sup>3</sup> So, too, the partnership audit rules adopted in TEFRA.

Neither the practical problems that drove creation of the TEFRA partnership audit rules nor the tax policy rationales used to justify them retain strength today. Indeed, almost thirty years of experience with those rules has unearthed numerous negative tax policy consequences. Furthermore, improvements in the substantive law applicable to partnerships and in the technology available to the IRS for use in auditing partnerships have significantly reduced the benefits derived from them. In short, their costs now outweigh their benefits. Accordingly, this Article argues that the TEFRA partnership audit rules should now be largely repealed. Only the requirement that each partner must report the tax consequences of the partnership's activities in a manner that is consistent with the partnership's tax return, or notify the IRS of that partner's inconsistency, should survive.<sup>4</sup>

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1. Wikipedia, 1970s, <http://en.wikipedia.org/wiki/1970s>.

2. Pub. L. No. 97-248, §§ 402-403, 96 Stat. 324, 648-69. Disco, bellbottoms, and ABBA gave way to techno-pop, tight-fitting leg warmers, and the likes of Madonna and Duran Duran. Wikipedia, 1980s, <http://en.wikipedia.org/wiki/1980s>. Of course, the *Star Wars* franchise was still red hot. See Wikipedia, 1980s in Film, [http://en.wikipedia.org/wiki/1980s\\_in\\_film](http://en.wikipedia.org/wiki/1980s_in_film) (listing *The Return of the Jedi* and *The Empire Strikes Back* as the second and third top-grossing films of the decade).

3. See Wikipedia, *Star Wars*, [http://en.wikipedia.org/wiki/Star\\_Wars](http://en.wikipedia.org/wiki/Star_Wars) (reporting U.S. box office revenue of only \$35 million for the 2008 release of *Star Wars: The Clone Wars*). Some might say the appeal vanished the moment Jar Jar Binks showed his computer-generated "face" in 1999's *The Phantom Menace*. See Wikipedia, Jar Jar Binks, [http://en.wikipedia.org/wiki/Jar\\_Jar\\_Binks](http://en.wikipedia.org/wiki/Jar_Jar_Binks) ("[Jar Jar Binks] is generally extremely despised by *Star Wars* fans. . . . The character was widely rejected and often ridiculed by sections of the series' fanbase, who felt that Jar Jar was clearly included in the film solely to appeal to children." (citation omitted)).

4. This requirement is currently found in I.R.C. § 6222. Without such a requirement, there is little reason to bother with the partnership tax return at all. Individual partners could "whiplash" the IRS by taking opposing tax positions

Part II of this Article lays the foundation necessary for a discussion of whether repeal is warranted. It begins by reviewing how the IRS's practical problems dealing with the large partnerships used in the tax shelter industry during the 1970s generated the push to reform the partnership audit procedures. Part II then surveys the tax policy rationales used to justify reform at that time before turning to a brief overview of the TEFRA partnership audit rules with an eye toward how they were intended to accomplish those policy rationales.

The case for repeal made in Part III of this Article has two main components. First, the Part evaluates the TEFRA partnership audit rules from a tax policy perspective — including their effectiveness in carrying out objectives underlying their adoption and their negative side effects — before concluding that the tax policy benefits are scant and the costs are not. Second, Part III focuses on the practical side of things. Here, this Article assesses the impact that subsequent technological improvements and changes to substantive partnership tax law have had on the practical problems faced by the IRS when dealing with partnership activities. Both these changed circumstances undermine the value of the TEFRA partnership audit rules. This Article concludes in Part IV that the TEFRA partnership audit rules “jumped the shark”<sup>5</sup> some time ago and should be repealed.

## II. THE TEFRA PARTNERSHIP AUDIT RULES

One cannot evaluate the relative merit of the TEFRA partnership audit rules without first understanding their origin and their operation. To that end, this Part explores the practical problem that resulted in their 1982 creation and the policy rationales used to justify them at that time. It also provides a brief overview of the TEFRA partnership audit rules themselves.

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regarding the same partnership activities — each picking the one most favorable to him or her — without the IRS's knowledge.

5. “Jump the shark” is “[t]he precise moment when you know a program, band, actor, politician, or other public figure has taken a turn for the worse, gone downhill, become irreversibly bad, is unredeemable, etc.; the moment you realize decay has set in.” Urban Dictionary, Jump the Shark, [http://www.urbandictionary.com/define.php?term=jump the shark](http://www.urbandictionary.com/define.php?term=jump%20the%20shark). The TV show *Happy Days* was the first to jump the shark when one of its main characters, Arthur “Fonzie” Fonzarelli, literally jumped over a shark while waterskiing during the show's fifth season in 1977. Footage of The Fonz's fateful leap can be seen online at YouTube, Fonzie Jumps the Shark, <http://www.youtube.com/watch?v=MDthMGtZKa4>.

A. *The Practical Problem That Spawned Them*

Given the extensive literature urging enactment of something like the TEFRA partnership audit rules during the late 1970s and early 1980s, and the legislative history accompanying TEFRA, there can be little doubt that the unprecedented tax shelter shenanigans occurring during that period prompted Congress to act.<sup>6</sup> The large limited partnerships used to mass market those tax shelters transformed what had been a manageable administrative challenge — auditing joint economic activity undertaken within a partnership — into a situation where “disputes rage on endlessly, reconciliation of differing views is virtually impossible, backlogs and frustrations build up, judicial calendars are clogged, and an important part of the tax administration system is threatened.”<sup>7</sup> From the Treasury Department’s perspective, this administrative mess prevented the IRS from effectively challenging the “highly questionable and sometimes illegal tax positions” taken by the tax shelter participants.<sup>8</sup> The tax practitioner community concurrently concluded that continuing to individually audit each partner for that partner’s share of the partnership’s joint economic activity was no longer viable.<sup>9</sup> The strain on administrative and judicial resources was simply too great.<sup>10</sup>

Most of the trouble stemmed from the aggregate/entity dichotomy imposed on tax partnerships.<sup>11</sup> Although a partnership engages in economic

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6. See, e.g., DEP’T OF THE TREASURY, THE PRESIDENT’S 1978 TAX PROGRAM 69 (1978) (“The Internal Revenue Service will be provided with a more effective tool to police partnerships, including tax shelter limited partnerships, by authorizing the Service to audit and make binding tax determinations at the partnership level.”); STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 268 (Comm. Print 1982) (attributing the need for statutory change to the “excessively burdensome” problems arising as “partnership syndications have developed and grown in recent years”).

7. AM. BAR ASS’N SECTION OF TAXATION, *Proposal as to Audit of Partnerships*, 32 TAX LAW. 551, 551 (1979).

8. DEP’T OF THE TREASURY, *supra* note 6, at 78–79.

9. AM. LAW INST., FEDERAL INCOME TAX PROJECT (pt. N) 13–17 (Tent. Draft No. 7, Mar. 20, 1981).

10. By 1979, more than 100,000 tax returns were suspended awaiting the resolution of partnership tax issues, and partnership issues accounted for roughly ten percent of the U.S. Tax Court’s case load. AM. BAR ASS’N SECTION OF TAXATION, *supra* note 7, at 551.

11. In contrast, most corporations are purely entities for tax purposes and do not have these problems. See I.R.C. § 11(a) (imposing tax on corporations). Corporations that elect flow-through taxation under subchapter S, giving them split personalities like partnerships, share many of the same audit issues faced by

activity as an entity,<sup>12</sup> the partnership is not itself a taxpayer.<sup>13</sup> Instead, the consequences of the partnership's economic activity flow through to its partners and are incorporated by them into their respective tax liability computations.<sup>14</sup> In this respect, the partnership is treated as little more than an aggregate of its partners and merely reports their collective activity to the IRS.<sup>15</sup> However, that aggregation approach is not without consequences. Because the tax consequences of the partnership activities are distributed to the partners, the tax issues relating to those activities replicate and disperse over multiple returns. Thus, to completely address the tax consequences of a partnership activity, in many cases the IRS must adjust each partner's tax return. As the number of partners increases, replication and dispersion of a partnership's tax issues can lead to IRS confusion and delay.<sup>16</sup> In light of the aggregate/entity dichotomy's multiplier effect, it should be no surprise that the administrative audit challenges created by a proliferation of large "investment" partnerships were legion.<sup>17</sup>

The administrative resource strain created by an audit of a large investment partnership began immediately after the IRS selected the

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partnerships. See Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 4, 96 Stat. 1669, 1691-92 (repealed 1996) (extending the TEFRA partnership audit rules to S corporations).

12. See, e.g., IND. CODE § 23-4-1-8(1) (2010) (permitting a partnership to acquire and own property directly).

13. I.R.C. § 701.

14. I.R.C. § 702(a).

15. I.R.C. § 6031(a) (requiring each partnership to file an information return "stating specifically the items of its gross income and the deductions allowable . . . and shall include in the return the names and addresses of the individuals who would be entitled to share in its taxable income if distributed").

16. The effect is much like the classic action scene where the hero struggles to pursue the villain through a house of mirrors and must repeatedly pause to decide whether any of the villain's images are actually the villain. See Wikipedia, House of Mirrors, [http://en.wikipedia.org/wiki/House\\_of\\_mirrors](http://en.wikipedia.org/wiki/House_of_mirrors) (listing famous chases like James Bond's pursuit of Francisco Scaramanga through a house of mirrors in *The Man with the Golden Gun* and describing Bruce Lee's solution to such a house in *Enter the Dragon*).

17. These partnerships were referred to as "investment" or "syndicated" partnerships because most of the partners were merely investors who had nothing to do with the partnership's operations and whose economic exposure was limited to their initial investment. In those respects, the partners were much like corporate shareholders. See DEP'T OF THE TREASURY, *supra* note 6, at 66-67. By comparison, "[t]he essence of the . . . partnership is the common conduct of a shared enterprise. The relationship among . . . partners contemplates that decisions important to the partnership normally will be made by common agreement or consent among the partners." *Hishon v. King & Spalding*, 467 U.S. 69, 79-80 (1984) (Powell, J., concurring) (citation omitted).

partnership's activities for audit. The IRS's first step was typically to find each partner and request a waiver of the partner's statute of limitations.<sup>18</sup> While finding each partner sounds easy, in practice the IRS often found its information was incomplete or out-of-date.<sup>19</sup> Furthermore, the partners in large investment partnerships were often spread over numerous audit districts throughout the country, which aggravated matters by increasing the internal coordination required of the IRS.<sup>20</sup> In some cases, the IRS had to work through multiple layers of partnerships to find the partners ultimately liable for tax on the audited partnership's activities.<sup>21</sup> According to the Treasury Department, these practical difficulties consumed significant resources and occasionally allowed partners to avoid the partnership audit entirely because their individual limitations periods expired before the IRS found them.<sup>22</sup>

After the IRS found the partners, its resource commitment to the partnership's audit did not necessarily decrease because each partner separately controlled when and where the partner's resulting tax liability would be determined.<sup>23</sup> At minimum, that distribution of power among the partners meant that the IRS had to pursue the audit of a single partnership issue on multiple, parallel tracks.<sup>24</sup> In extreme cases, the partners in a partnership could collectively do all of the following at once at the administrative level: (i) force the IRS to issue a premature notice of deficiency addressing the partnership issue by not agreeing to a statute of limitations waiver, (ii) accept the IRS's position on the partnership issue after completion of the audit examination, and (iii) appeal the results of the IRS's examination within the IRS.<sup>25</sup> This fractionalization apparently prolonged audits by discouraging both the IRS and the taxpayers from settling partnership tax issues.<sup>26</sup>

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18. DEP'T OF THE TREASURY, *supra* note 6, at 122. In most cases, a partner's statute of limitations was three years from the later of the date the partner filed his or her individual income tax return or the return's unextended due date (i.e., Apr. 15th). I.R.C. § 6501(a), (b)(1).

19. DEP'T OF THE TREASURY, *supra* note 6, at 122.

20. AM. LAW INST., *supra* note 9, at 14.

21. *Id.*

22. DEP'T OF THE TREASURY, *supra* note 6, at 122. Congress agreed. STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., *supra* note 6, at 268 ("Large partnerships with partners in many audit jurisdictions result in the statute of limitations expiring with respect to some partners while other partners are required to pay additional taxes.").

23. DEP'T OF THE TREASURY, *supra* note 6, at 123.

24. AM. LAW INST., *supra* note 9, at 14-15.

25. *Id.* at 15.

26. STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., *supra* note 6, at 268. The conventional wisdom regarding this anti-settlement side effect was that the

The IRS's exposure to duplication of effort did not end with completion of administrative review. The partners could pursue the partnership issue in the U.S. Tax Court,<sup>27</sup> their respective U.S. District Courts, and the Court of Claims.<sup>28</sup> Successful litigation against one partner did not resolve the matter for the other partners because the other partners were not parties to that litigation.<sup>29</sup> Thus, the IRS could be forced to completely rehash the same underlying partnership tax issue with each and every partner.

The above-described resource demands on the IRS and the courts were not new in 1978 when the Treasury Department started the legislative push that culminated in the TEFRA partnership audit rules.<sup>30</sup> Neither were the problems they created.<sup>31</sup> In fact, both were considered manageable by both the Treasury Department and the tax practitioner community until "vastly compounded by the widespread use of partnerships in the tax shelter area."<sup>32</sup>

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IRS gained little from settling with one partner because it would still have to incur litigation costs with other partners and that both sides feared looking stupid if subsequent litigation involving other partners concluded more favorably than anticipated. AM. LAW INST., *supra* note 9, at 16.

27. See I.R.C. §§ 7421(a), 6213(a). Partners seeking to avoid payment of the tax resulting from the IRS's conclusions about the partnership issue challenged the IRS's deficiency determination in U.S. Tax Court before that determination became final. *Id.*

28. 28 U.S.C. § 1346(a)(1) (granting jurisdiction over "[a]ny civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected"). The ability to litigate in the U.S. District Courts and the Court of Federal Claims is preserved for TEFRA partnership audits today, despite the fact that the partners are not actually making refund claims, so long as the partners deposit the taxes at stake with the court. I.R.C. § 6226(e)(1).

29. *Hansberry v. Lee*, 311 U.S. 32, 40 (1940) ("It is a principle of general application in Anglo-American jurisprudence that one is not bound by a judgment in personam in a litigation in which he is not designated as a party or to which he has not been made a party by service of process."). The normal rules of issue preclusion or res judicata apply to tax litigation. *Comm'r v. Sunnen*, 333 U.S. 591, 597-98 (1948).

30. DEP'T OF THE TREASURY, *supra* note 6, at 123.

31. AM. LAW INST., *supra* note 9, at 13.

32. DEP'T OF THE TREASURY, *supra* note 6, at 123; *accord* AM. LAW INST., *supra* note 9, at 13; AM. BAR ASS'N SECTION OF TAXATION, *supra* note 7, at 551. After the TEFRA partnership audit rules took effect, numerous commentators reviewed and elaborated on the nature of these problems. *E.g.*, Claudine Ausness, *Partnership Level Proceedings: Policies, Procedures and Planning*, 72 KY. L.J. 89, 89-92 (1983); Jay Rosen, *TEFRA's New Partnership Auditing Procedures: Was the Small Partner Left Out?*, 38 TAX L. REV. 479, 480-83 (1982); L. Glenn Worley, *The*



*B. Policy Justifications*

At 50,000 feet, tax policy discussions often boil down to three main criteria — fairness/equity, simplicity/ease of administration, and economic efficiency.<sup>33</sup> As is no doubt clear from the preceding discussion, the TEFRA partnership audit rules were primarily intended to improve the tax system's fairness<sup>34</sup> — both among the partners and between the partners and other taxpayers — and the IRS's ability to efficiently and effectively administer the tax laws when dealing with partnerships.<sup>35</sup> A hoped for, but indirect, benefit was undoubtedly the increased economic efficiency derived from deterring future unproductive tax-motivated sheltering activities.<sup>36</sup> Arguably, even if streamlined audit procedures did not discourage tax shelters, they would still improve overall economic efficiency by permitting the partners (and the IRS) to redirect some of their energies away from resolving the audit toward generating additional wealth (or, in the IRS's case, pursuing other tax revenue).<sup>37</sup>

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*Tax Treatment of Partnership Items Act of 1982: Pragmatic Procedures for Determining Partners' Shares of Partnership Income*, 14 MEM. ST. U. L. REV. 1, 2-9 (1983).

33. MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 28 (6th ed. 2009). Here, economic efficiency "requires that a tax interfere as little as possible with people's economic behavior." *Id.* at 29.

34. See THE PRESIDENT'S 1978 TAX REDUCTION AND REFORM PROPOSALS: HEARINGS BEFORE THE H. COMM. ON WAYS & MEANS, 95th Cong. 35 (1978) [hereinafter PRESIDENT'S 1978 PROPOSALS] (statement of W. Michael Blumenthal, Secretary of the Treasury) (characterizing "auditing at the partnership level" as a proposal targeted at "unfair and unjust" tax shelters).

35. H.R. REP. NO. 97-760, at 600 (1982) (Conf. Rep.), as reprinted in 1982 U.S.C.C.A.N. 1190, 1372; see also PRESIDENT'S 1978 TAX PROPOSALS, *supra* note 34, at 5828 (statement of Jerome Kurtz, Commissioner of Internal Revenue) ("This proposal is addressed to the serious administrative difficulties the Internal Revenue Service is experiencing in effectively auditing partnerships and assessing tax liabilities against partners with respect to items involved in their partnerships.").

36. DEP'T OF THE TREASURY, *supra* note 6, at 129 ("Given the fact that under current law, most shelter investors do not take the possibility of extensive IRS audit seriously, it may be expected that the full implementation of [Treasury's partnership audit] proposal will have a significant impact on shelter activity."); see also H.R. REP. NO. 97-760, at 600 (1982) (Conf. Rep.) (espousing promotion of "increased compliance" as one purpose for the TEFRA partnership audit rules), reprinted in 1982 U.S.C.C.A.N. 1190, 1372.

37. See Graetz & Schenk, *supra* note 33, at 28 (recognizing that simplicity/ease of administration and economic efficiency are interconnected because complex tax rules require taxpayer and the IRS to divert time from other activities). The Commissioner clearly hoped for less burdensome audits.

These tax policy objectives shaped the broad contours of the TEFRA partnership audit rules. Improved fairness among the partners encouraged shifting the audit's focus to the partnership by adopting procedures that (i) produced a single partnership-level determination regarding the tax treatment of the partnership's activities, (ii) decreased partner ability to deviate from the partnership's tax positions, (iii) reduced partner control over resolution of the partnership's tax issues, and (iv) employed a statute of limitations tied to the partnership, not the partners.<sup>38</sup> The new procedures' entity-level focus was also expected to simplify administration for the IRS and reduce economically-inefficient demands on the partners' resources.<sup>39</sup> Improved fairness between the partners and other taxpayers would result when the new audit rules prevented tax shelter purchasers from using large partnerships to illegally evade taxes without facing IRS scrutiny.<sup>40</sup> Of course, the devil is in the details.

### C. Operational Basics

And what details they are! The statutory structure comprising the audit procedures for partnerships are largely intact and unmodified since their addition to the Internal Revenue Code (the "Code") in 1982.<sup>41</sup> While understanding the operational basics of these procedures is needed to

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PRESIDENT'S 1978 TAX PROPOSALS, *supra* note 34, at 5836 (statement of Jerome Kurtz, Commissioner of Internal Revenue) ("I do not view this administrative proposal as a complicating change in the law for anyone. It will simplify the administrative process as far as the IRS is concerned and we don't see it would add burdens to taxpayers.").

38. See DEP'T OF THE TREASURY, *supra* note 6, at 123 (noting a "lack of uniformity and consistency" as one problem to be corrected by auditing partnership activities at the partnership entity level); see also AM. LAW INST., *supra* note 9, at 16-17, 19-20 (raising the possibility of inconsistent results for the partners as one justification for entity-level audits).

39. PRESIDENT'S 1978 TAX PROPOSALS, *supra* note 34, at 5833 (statement of Jerome Kurtz, Commissioner of Internal Revenue); AM. LAW INST., *supra* note 9, at 14-15 (describing "great duplication of effort and coordination problems on the part of . . . the taxpayers' representatives" as a problem to be resolved by the proposed partnership audit rules).

40. DEP'T OF THE TREASURY, *supra* note 6, at 79.

41. Compare Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 402(a), 96 Stat. 324, 648-79, with I.R.C. §§ 6221-34. The most significant revisions, which were still relatively minor from a structural perspective, came in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §§1231-43, 111 Stat. 788, 1020-30.

evaluate their ongoing desirability, a granular explanation of them is beyond the scope of the Article and is well-traveled ground.<sup>42</sup>

When enacted, the TEFRA partnership audit rules fundamentally shifted the audit from a partner-centric aggregate approach to one focusing on the partnership as an entity.<sup>43</sup> Thus, the "tax treatment of any partnership item" is now "determined at the partnership level."<sup>44</sup> Partnership items are those items from the relevant taxable year that Treasury regulations indicate are "more appropriately determined at the partnership level than at the partner level."<sup>45</sup> Common examples of such items include each partner's share of the partnership's income, gain, loss, deductions, credits,<sup>46</sup> non-deductible expenditures,<sup>47</sup> and liabilities;<sup>48</sup> and the factors that underlie the determination of those amounts.<sup>49</sup> Penalties and other additions to tax are also partnership items to the extent they relate to partnership items.<sup>50</sup>

TEFRA also created a second level of adjustments for affected items.<sup>51</sup> These affected items are not themselves partnership items and may not be directly related to the partnership return, but they are affected by the partnership items.<sup>52</sup> For that reason, they are recomputed after the adjustments to partnership items are determined.<sup>53</sup> If no partner-level considerations are necessary to finally determine the affected item's amount,

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42. See, e.g., John B. Palmer III, *TEFRA Treats Partnerships as Separate Entities Under Its New Procedural Rules*, 58 J. TAX'N 34, 35-39 (1983); Ausness, *supra* note 32, at 89, 92-139.

43. Carmen D. Tucker Bakarich, *Auditing the Partnership: The Rules and the Complications*, 31 WASHBURN L.J. 18, 18-19 (1991).

44. I.R.C. § 6221.

45. I.R.C. § 6231(a)(3).

46. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i).

47. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(ii).

48. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(v).

49. *Id.* § 301.6231(a)(3)-1(b). Such factors include the partnership's accounting method and the factual and legal determinations contributing to the resulting tax treatment. *Id.*

50. I.R.C. § 6221. Notably, partner-level defenses (e.g., whether the partner had reasonable cause for taking a particular position) are not partnership items. Treas. Reg. § 301.6221-1(d).

51. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 402(a), § 6231(a)(5), 96 Stat. 324, 663.

52. I.R.C. § 6231(a)(5); Treas. Reg. § 301.6231(a)(5)-1(a). Affected items include items that vary with "the individual partner's adjusted gross income," the partner's basis in the partnership interest, and the partner's at-risk limitations. Treas. Reg. § 301.6231(a)(5)-1(a) to (c).

53. N.C.F. Energy Partners v. Comm'r, 89 T.C. 741, 744 (1987).

then the resulting tax and penalties due may be computed immediately.<sup>54</sup> However, if the affected item also depends on additional partner-level determinations, the IRS may not assess the related tax and penalties without completing deficiency proceedings at the partner level.<sup>55</sup>

Streamlining of the administrative review process and equity among the partners are strongly encouraged by making it more difficult, but not impossible, for the partners to stray from the partnership fold. Initially, partners are required to either treat partnership items flowing through to their tax returns in the same manner that those items are reported on the partnership's return or to notify the IRS that they are not doing so.<sup>56</sup> Failure to notify of a deviation empowers the IRS to impose conformity through automatic adjustment of the noncomplying partner's return<sup>57</sup> and exposes that partner to penalties.<sup>58</sup> Once the returns are filed, the IRS generally has three years from the later of the partnerships filing date or the individual partners' filing dates to assess additional tax resulting from the adjustment of partnership items.<sup>59</sup> That period can be extended for all partners by an

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54. Treas. Reg. § 301.6231(a)(6)-1(a)(1); *see also N.C.F. Energy Partners*, 89 T.C. at 744. Items that vary with the individual partner's adjusted gross income are good examples of affected items that do not require an additional partner-level proceeding. Treas. Reg. § 301.6231(a)(6)-1(a)(2).

55. Treas. Reg. § 301.6231(a)(6)-1(a)(1); *see also N.C.F. Energy Partners*, 89 T.C. at 744-45. Often, the partner's amount at risk in the partnership requires a partner-level determination. Treas. Reg. § 301.6231(a)(6)-1(a)(3).

56. I.R.C. § 6222(a), (b)(1). The partnership is required to provide each partner with a copy of the partnership's tax return, I.R.C. § 6031(b), and the return must show "the partner's distributive share of partnership income, gain, loss, deduction, or credit required to be shown on the partnership return" and any other information specified by the IRS on the partnership tax return form or instructions. Temp. Treas. Reg. § 1.6031(b)-1(a)(3).

57. I.R.C. § 6222(c). Normally, the IRS cannot assess additional tax resulting from adjustment of a partnership item without conducting a partnership-level proceeding. I.R.C. § 6225(a).

58. I.R.C. § 6222(d).

59. I.R.C. §§ 6229(a), 6501(a). Whether the individual partners' limitations periods were relevant has been the subject of extensive litigation in recent years, but the matter appears to be largely resolved. *Curr-Spec Partners L.P. v. Comm'r*, 579 F.3d 391, 393 (5th Cir. 2009) (joining the U.S. Tax Court, the Federal Circuit, and the D.C. Circuit in their interpretation of the interplay between I.R.C. §§ 6229 and 6501), *cert. denied*, 130 S. Ct. 3321 (2010); *see also* Darryll K. Jones, *The Labyrinthine and Expensive Partner Limitations Period*, 112 TAX NOTES 681, 683 (2008) (lamenting the high cost of determining I.R.C. § 6229(a)'s correct meaning). Of course, special circumstances, such as the partnership's failure to file a tax return, or the filing of a fraudulent tax return, generate longer limitations periods. *See* I.R.C. § 6229(c) (extending to at least six years for fraudulent returns and forever for an ongoing failure to file situation).

agreement between the partnership's tax matters partner (the "TMP"),<sup>60</sup> who functions as the point person for the partnership,<sup>61</sup> and the IRS.<sup>62</sup> Other partners can extend their individual limitations periods by direct agreement with the IRS.<sup>63</sup>

If the IRS believes that adjustments to the partnership items reported on the partnership's tax return are necessary, it cannot make those adjustments without first conducting a partnership-level audit.<sup>64</sup> Despite the apparent efficiency-driven emphasis on a partnership-level audit, considerable individual partner involvement is still possible. The partnership-level audit begins when the IRS sends an audit notice to each partner that has been identified on the partnership's tax return.<sup>65</sup> To reduce the administrative burden on the IRS, notice is not required for partners owning less than one percent of the profits of a partnership with more than 100 partners (the "small partners").<sup>66</sup> Once the partnership-level audit is underway, the TMP is charged with keeping the other partners up to date on the audit's progress.<sup>67</sup> However, each partner — even the small partners not entitled to notice of the audit — may participate in that audit.<sup>68</sup> Each partner may also individually

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60. Unless the partners designate a TMP, that title falls to the general partner presumed to have the most at stake (i.e., the one with "the largest profits interest in the partnership at the close of the tax year involved"). I.R.C. § 6231(a)(7).

61. See Rosen, *supra* note 32, at 500-04 (likening the TMP to a class representative in class action suits).

62. I.R.C. § 6229(b)(1)(B).

63. I.R.C. § 6229(b)(1)(A).

64. I.R.C. § 6225(a).

65. I.R.C. § 6223(a)(1). Of course, if the IRS has received additional contact information from the partners, it will use that information. Treas. Reg. § 301.6223(c)-1(a). Where a partner is itself a partnership, or some other pass-through entity, the IRS will send notices to the indirect partners when it is aware of them, I.R.C. § 6223(c)(3), but the pass-through partner itself is also required to forward the notice on to the indirect partners. I.R.C. § 6223(h)(1).

66. I.R.C. § 6223(b)(1). As will become clear, small partners are denied certain rights to dispute the IRS's position on partnership items. However, they can recover those rights by banding together with other partners owning, in the aggregate, five-percent or more of the partnership's profits interest. I.R.C. § 6223(b)(2). Because these five-percent groups are not particularly relevant to this Article's discussion, to simplify matters they are largely ignored.

67. I.R.C. § 6223(g); see also Treas. Reg. § 301.6223(g)-1(b)(1) (listing events that the TMP must inform the other partners about).

68. I.R.C. § 6224(a). In practice, this right may be of little use to any but the most vigilant partners because the IRS and the TMP select the time and place of all audit events, are not required to notify the other partners of most such events, and are not required to change time or location for them to accommodate other partners. Treas. Reg. § 301.6224(a)-1(a); Bakarich, *supra* note 43, at 38-39.

settle the tax treatment of the partnership items under audit with the IRS.<sup>69</sup> If the TMP enters into a settlement agreement with the IRS and expressly provides that the agreement will bind the small partners, then those small partners are bound by the TMP's agreement.<sup>70</sup> Other partners may elect to receive the same settlement terms.<sup>71</sup> This right to receive the same terms applies to any settlement agreement between the IRS and any partner.<sup>72</sup>

Of course, some partnership audits are not settled — at least not by all the partners. When that happens, the IRS issues a notice of a final partnership administrative adjustment (an "FPAA")<sup>73</sup> and the partners must decide whether to litigate the matter. Each partner who isn't a small partner is entitled to notice of the FPAA's issuance.<sup>74</sup> For the first ninety days after its issuance, the TMP alone can challenge the FPAA in court.<sup>75</sup> The TMP's forum choices are the Tax Court, the district court of the district containing the partnership's principal place of business, and the Court of Federal Claims.<sup>76</sup> If the TMP does not file a petition for readjustment of the FPAA, then any partner (other than a small partner) can request judicial readjustment within the next sixty days but only one such request will survive.<sup>77</sup> The rest are dismissed,<sup>78</sup> and all partners having an interest in the

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69. I.R.C. § 6224(c)(1).

70. I.R.C. § 6224(c)(3). Even here, the efficiency focus is diffused if a small partner files a statement with the IRS stripping the TMP of this power more than thirty days before the TMP's settlement agreement. Treas. Reg. § 301.6224(c)-1(a)(2).

71. I.R.C. § 6224(c)(2).

72. *Id.*

73. See I.R.C. § 6225(a)(1) (requiring an FPAA before the IRS can assess a deficiency resulting from a partnership item).

74. I.R.C. § 6223(a)(2), (b)(1).

75. I.R.C. § 6226(a).

76. *Id.* The heated debate over which forum is best for taxpayers and the IRS has raged in the tax community for quite some time, but that debate is beyond the scope of this Article. See, e.g., Paul L. Caron, *Tax Myopia, or Mamas Don't Let Your Babies Grow Up To Be Tax Lawyers*, 13 VA. TAX REV. 517, 574-81 (1994) (discussing commentary on this topic going back to 1954 and comparing commentator claims with empirical data); David B. Porter, *Where Can You Litigate Your Federal Tax Case?*, 98 TAX NOTES 558, 559-60 (2003) (weighing the benefits and costs of the alternatives); Paul E. Treusch, *What to Consider in Choosing a Forum to Resolve an Ordinary Tax Dispute*, 55 TAX LAW. 83 (2001) (same); Thomas D. Greenaway, *Choice of Forum in Federal Civil Tax Litigation*, 62 TAX LAW. 311 (2009) (same).

77. I.R.C. § 6226(b)(1). Statutory tiebreaker rules give primacy to the first action filed in Tax Court, followed by the first action filed in any other court. I.R.C. § 6226(b)(2), (3).

78. I.R.C. § 6226(b)(4).

outcome are deemed a party to the surviving action and are permitted to participate.<sup>79</sup> The court proceeds to determine the partnership items at issue, including their allocation among the partners if that is disputed, and any related matters (e.g., the application of penalties resulting from the partnership items' adjustment).<sup>80</sup> Any partner (other than a small partner) can appeal the court's decision.<sup>81</sup> In this manner, the IRS and the courts are protected from multiple judicial proceedings resolving the tax treatment of the same partnership item.

If the partners decide not to challenge the IRS's FPAA, or upon final determination of the partnership items in court, the IRS is authorized to make computational adjustments that correct the partners' tax liabilities and "properly reflect[] the treatment of . . . [the] partnership item[s]."<sup>82</sup> At that point, the partners can no longer dispute substantive legal issues and are limited to asserting that the IRS's adjustment failed to carry out the FPAA or court's decision.<sup>83</sup>

Partner-initiated requests for administrative adjustment of partnership items follow a similar path intended to encourage the efficient resolution of partnership issues by the IRS. When the TMP makes such a request, the IRS may make the adjustment for all partners, initiate a partnership-level audit under the rules described above, or ignore the request.<sup>84</sup> When the request comes from any other partner, the IRS can handle the matter on an individual level directly with the requesting partner (i.e., adjust only that partner's tax liability) or can elevate the request to the partnership level by conducting a partnership-level audit.<sup>85</sup> Judicial challenge of an IRS decision to reject the TMP's administrative adjustment request can only be made by the TMP and results in the other partners being treated as parties to the litigation if they have an interest in the outcome.<sup>86</sup> Any other partner may file suit disputing the IRS's rejection of that partner's

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79. I.R.C. § 6226(c)(1), (d).

80. I.R.C. § 6226(f).

81. I.R.C. § 6226(g).

82. I.R.C. § 6231(a)(6); Treas. Reg. § 301.6231(a)(6)-1(a)(1).

83. I.R.C. § 6230(c)(1), (4). A partner can also challenge the IRS's assertion of a penalty against the partner because of the adjustment to the partnership items. I.R.C. § 6230(c)(1)(C).

84. I.R.C. § 6227(c)(2). The TMP, and only the TMP, may also file a substitute partnership tax return. I.R.C. § 6227(c)(1). Under those circumstances, the IRS may simply adjust the partnership items on all the partners' tax returns and assess any additional tax due. I.R.C. §§ 6227(c)(1), 6230(b)(1).

85. I.R.C. § 6227(d). Interestingly, the IRS can use the request to actually sever the partner from the partnership for the purpose of future adjustments to partnership items by declaring that all that partner's partnership items for the year in question will be nonpartnership items going forward. I.R.C. § 6227(d)(3).

86. I.R.C. § 6228(a)(1), (4).

administrative adjustment request, but doing so removes resolution of that partner's case from the reach of the TEFRA audit procedures.<sup>87</sup>

The procedures described above encourage a uniform, entity-level resolution of partnership issues and discourage individual partners from deviating from that common result at each step of the partnership audit. Clearly Congress and the Treasury Department enacted them hoping to accomplish their goals of improved fairness, increased economic efficiency, and reduced administrative burdens for the IRS and the partners.<sup>88</sup> Arguably, they succeeded to some degree along each of these dimensions, but not entirely.<sup>89</sup>

### III. THE CASE FOR REPEAL

This Article's case for repeal weighs the relative costs and benefits of retaining the TEFRA partnership audit rules from policy and practical perspectives. The policy portion evaluates the extent to which the TEFRA partnership audit rules fully accomplish the tax policy objectives underlying their adoption and considers negative side effects that could weaken the justification for retaining them. This Part concludes that, from a tax policy perspective, the TEFRA partnership audit rules have provided fewer benefits than anticipated and have created significant costs. Turning to the practical, this Part next examines how factual and legal limitations on the TEFRA partnership audit rules' scope reduce the magnitude of any benefits derived from them by excluding many partnerships from their reach. Finally, the Part assesses the impact that subsequent technological improvements and changes to substantive partnership tax law have had on the real-world problems that confronted the IRS when it attempted to audit partnership activities before TEFRA. Both these changed circumstances undermine the value of the TEFRA partnership audit rules by reducing the gravity of the practical problems that they address.

#### A. Effectiveness in Accomplishing Goals

The struggle to strike the proper balance between treating partnerships as a separate entity or an aggregate of the partners is not new or

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87. I.R.C. § 6228(b)(2). If the IRS exercised its power to sever the partner from the rest of the partnership by transforming the partner's partnership items into nonpartnership items in response to the partner's administrative adjustment request, then the partner's petition simply proceeds at an individual level from the start. I.R.C. § 6228(b)(1).

88. See *supra* Part II.B.

89. See *infra* Part III.A.



unique to partnership audits.<sup>90</sup> As noted by numerous commentators, the balancing decision often involves tradeoffs between simplicity, fairness, and efficiency<sup>91</sup> — the same tax policy considerations used to justify enactment of the entity-level TEFRA partnership audit rules.<sup>92</sup> Accordingly, the TEFRA partnership audit rules' effectiveness in accomplishing the goals set out for them is considered along each of those lines below.

### 1. Simplification/Administrability

One major objective for the TEFRA partnership audit rules was simplifying the IRS's audit procedures to make administering those audits more efficient and effective.<sup>93</sup> Evaluating the rules' success along this line isn't easy because, when it comes to taxes, even simplicity isn't simple.<sup>94</sup> In

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90. See Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717, 722–23, 781–83 (2009) (reviewing the historical development of the aggregate/entity dichotomy and providing a table classifying specific substantive partnership tax provisions as either “aggregate” or “entity”). The controversy is not even limited to tax. See, e.g., A. Ladru Jensen, *Is a Partnership Under the Uniform Partnership Act an Aggregate or an Entity?*, 16 VAND. L. REV. 377, 379 (1963) (“This compromise produced ambiguities between the numerous specific provisions of the [Uniform Partnership Act] espousing the entity principle and the act's general aggregate definition. These ambiguities became, and to a considerable degree still remain, a source of legal controversy as different problems arise.”).

91. See, e.g., Philip F. Postlewaite, *I Come to Bury Subchapter K, Not to Praise It*, 54 TAX LAW. 451, 456–57 (2001) (recounting the American Law Institute's comparison of the conduit (i.e., aggregate) and entity approaches to taxing private business enterprises (e.g., partnerships) along the lines of equity, efficiency, and administrative concerns); Borden, *supra* note 90, at 723 (comparing two approaches to resolution of the aggregate/entity dichotomy using metrics of simplicity, accuracy, and efficiency); Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1072–74 (2006) (inferring Congressional preference for aggregate treatment so that the partners are treated fairly in comparison to individual taxpayers and arguing that the preference partially relies on efficiency objectives that are sometimes overwhelmed by administrative concerns). The tradeoffs exist in the rest of the tax world too. See Gerard M. Brannon, *Simplification and Other Tax Objectives*, in FEDERAL INCOME TAX SIMPLIFICATION 191, 193–200 (Charles H. Gustafson ed., 1979) (providing a traditional analysis of the simplification, equity, and efficiency tradeoffs).

92. See *supra* Part II.B.

93. See *supra* note 35 and accompanying text.

94. See, e.g., Steve R. Johnson, *The E.L. Wiegand Lecture: Administrability-Based Tax Simplification*, 4 NEV. L.J. 573, 581–82 (2004) (considering detail complexity, outcome complexity, and forms complexity); DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 266–67 (1986) (distinguishing three

the words of one commentator, simplicity may mean “more easily understood statutory language, increased efficiency of tax administration, greater certainty in planning, more understandable forms, or more coherent resolution of tax issues by the courts.”<sup>95</sup> The simplicity analysis in this Article centers on procedural complexity,<sup>96</sup> which refers to the problems faced by taxpayers and the IRS in dealing with the procedural aspects of a partnership audit, and rules complexity, which “refer[s] to the problems of interpreting the written and unwritten rules” governing that audit.<sup>97</sup> At times, these two forms of complexity may be inversely related to each other.<sup>98</sup> Needless to say, there are numerous ways to assess whether a particular tax system is too complex depending on whether one’s focus is on taxpayers, the IRS, or the tax law itself.<sup>99</sup> All three perspectives are considered here.

This Article’s simplicity analysis begins by examining the impact that the TEFRA partnership audit rules have had on the procedural complexity that the IRS faces when auditing partnership activities and taxpayers confront when participating in that audit. Arguably, those rules have produced the greatest benefit streamlining the IRS’s audit process — at least in the limited circumstances where the rules apply. Taxpayers can benefit from this streamlining, too, but at the cost of some lost involvement in, and control over, the partnership’s audit. For both sides, the streamlined audit’s simplification benefits are diluted by the complex procedures necessary to avoid trampling on the partners’ traditional rights and by the fact that, in certain circumstances, the audit rules do not avoid the need for multiple levels of litigation when resolving whether the partnership’s activities cause the partners to owe additional taxes and penalties. In

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types of complexity — compliance, transactional, and rule); Charles E. McLure, Jr., *The Budget Process and Tax Simplification/Complication*, 45 TAX L. REV. 25, 42–43 (1989) (same).

95. Paul R. McDaniel, *Federal Income Tax Simplification: The Political Process*, in FEDERAL INCOME TAX SIMPLIFICATION, *supra* note 91, at 507, 509.

96. Procedural complexity is a variant of what Prof. Bradford refers to as “compliance complexity (referring to the problems faced by the taxpayer in keeping records, choosing forms, making necessary calculations, and so on).” Bradford, *supra* note 94, at 266–67; *see also* Johnson, *supra* note 94, at 599 (recognizing that TEFRA’s “notice and participation rules create a variant on forms complexity” under his classification system).

97. BRADFORD, *supra* note 94, at 267.

98. *Id.* at 266.

99. *See* Harvey Galper and Michael Kaufman, *Simplification and Comprehensive Tax Reform*, in FEDERAL INCOME TAX SIMPLIFICATION, *supra* note 91, at 161, 163–65 (recognizing the need to identify the various tax system participants — including taxpayers and administrators — when determining the degree of complexity in that system).

addition, small partners<sup>100</sup> face a number of “traps for the unwary” under the new procedures that can further offset those benefits.

The remainder of this Section describes how the TEFRA partnership audit rules undermined rules simplicity by injecting complexity and uncertainty into the tax law.<sup>101</sup> At a superficial level, the audit rules add a subchapter to the Code consisting of thirteen intertwined sections and extensive accompanying Treasury regulations.<sup>102</sup> Furthermore, because the TEFRA partnership audit rules only apply to partnership items, they do not relieve the partners from dealing with the pre-existing audit rules that apply outside the partnership context.<sup>103</sup> Thus, the partners face two sets of complicated, and parallel, audit procedures. Perhaps not surprisingly, classification issues arising from the need to sort out whether the main regime or the special partnership regime applies in a given circumstance have resulted in a great deal of litigation.<sup>104</sup> More mundane statutory interpretation problems have also contributed to diminished rules simplicity.<sup>105</sup> Taken together, these two complicating factors led one pair of exasperated practitioners to declare that the TEFRA partnership audit rules

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100. See *supra* text accompanying note 66 (defining “small partner”).

101. “‘Simplicity of rules’ is lacking when the Code and its supporting regulations can be interpreted only by ‘a tiny priesthood of lawyers and accountants,’ and, by them, only with great difficulty.” McLure, *supra* note 94, at 42. Prof. Johnson refers to this variant as “outcome complexity.” Johnson, *supra* note 94, at 582.

102. See I.R.C. §§ 6221-6234 (comprising Subchapter C of Chapter 63 of the Code). No less than fifty-five Treasury regulations elaborate on those sections. Treas. Reg. §§ 301.6221-1 to 301.6233-1.

103. I.R.C. § 6221. Subchapter B of Chapter 63 of the Code applies to taxpayers outside of the partnership context. I.R.C. § 6211(a).

104. Often, this issue comes up when a taxpayer contests whether the statute of limitations for assessing additional tax has expired because the IRS, acting on its belief that the tax resulted from a partnership item, pursued the taxpayer using the TEFRA partnership audit rules and let the partner’s individual limitations periods expire. See, e.g., Estate of Quick v. Comm’r, 110 T.C. 172, 182–83 (1998) (considering whether losses from a partnership could be recharacterized as passive losses subject to limitation under I.R.C. § 469 at the partner level when the IRS had mounted a timely challenge under the TEFRA partnership audit rules after the partner’s individual limitations period had expired for items not connected to the partnership), supplemented by 110 T.C. 440 (1998). In cases where it is unclear whether the TEFRA partnership audit rules apply, the IRS instructs its field agents to protect the government’s interest by extending both the partnership’s and the partners’ limitations periods if possible. INTERNAL REVENUE MANUAL § 4.31.2.1.8(3), [http://www.irs.gov/irm/part4/irm\\_04-031-002.html](http://www.irs.gov/irm/part4/irm_04-031-002.html).

105. See *supra* note 59 and accompanying text (describing the statute of limitations controversy that has been the most litigated, and significant, statutory interpretation issue in this area).

“may have become a greater procedural problem than what remains of the procedural problems they were adopted to solve.”<sup>106</sup>

*a. Procedural Simplicity: Streamlining's Benefits and Costs*

The TEFRA partnership audit rules are at their best streamlining the review of partnership items for the IRS, the partners, and the courts. They accomplish that objective by shifting from a purely aggregate procedural approach focused on the individual partners to one that is predominately focused on the partnership as an entity.<sup>107</sup> The three key components of that shift are a unified minimum limitations period for partnership items that applies to all partners, a single audit of the partnership items performed at the administrative level, and a single judicial review of that audit.<sup>108</sup> Instead of having to identify and locate each partner, some of whom are in different audit districts, in time to request a waiver of that partner's personal statute of limitations before it expires, the IRS can now obtain a single waiver applying to all partners from the TMP.<sup>109</sup> This simplifying change clearly benefits the IRS from an administrative standpoint by reducing the effort and resources required to keep the limitations period open for taxes related to partnership items.

Consolidation of the partners' separate audits and court proceedings into a single partnership audit and judicial review creates similar administrative simplification benefits for the IRS and the courts. At minimum, that consolidation ended the problem of multiple, parallel audits addressing the same partnership issue that so vexed the IRS prior to TEFRA.<sup>110</sup> In addition, the TEFRA partnership audit rules permit the IRS to focus its attention on the TMP, which means that only one audit team from one audit district is needed to handle the audit regardless of where the various partners are located.<sup>111</sup> Furthermore, while it is true that all partners may participate in the partnership audit, the IRS is not required to notify the other partners of ongoing audit activities or to adjust the audit schedule to

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106. Burgess J.W. Raby and William L. Raby, *TEFRA Partnership Rules: The Solution Becomes the Problem*, 88 TAX NOTES 795, 795 (2000).

107. Johnson, *supra* note 94, at 596–97.

108. *See supra* notes 59–81 and accompanying text (summarizing the statutory provisions establishing these three components).

109. I.R.C. § 6229(b)(1)(B); *see supra* text accompanying notes 18–22 (describing the IRS's statute of limitations waiver problems before TEFRA).

110. *See supra* notes 23–26 and accompanying text (laying out the causes and consequences of each partner's power to control where and when that partner's resulting tax liability would be resolved).

111. Treas. Reg. § 301.6224(a)-1(a).

accommodate them in any way.<sup>112</sup> Consequently, the bulk of the day-to-day audit activity typically involves only the IRS and the TMP.<sup>113</sup> When it comes to settling the audit, the simplification benefits to the IRS can be even more pronounced when small partners are present because a settlement agreement with the TMP can bind those small partners too.<sup>114</sup> That binding, combined with the IRS's obligation to offer the same settlement deal to all partners and the consolidation of any subsequent judicial review for non-settling partners, diffuses much of the anti-settlement side effects created under the pre-TEFRA audit procedures.<sup>115</sup> Once the matter goes to the courts, what could be simpler for the IRS — and the courts — than one consolidated proceeding where all partners are parties and are bound by the decision?<sup>116</sup> No more duplicated efforts in different fora.<sup>117</sup>

Without question, the procedural simplification resulting from adoption of a uniform, entity-level procedure for resolving partnership issues benefits the IRS. It can benefit taxpayers, too, by reducing and facilitating sharing of audit and litigation costs.<sup>118</sup> Of course, for taxpayers that reduction and sharing of costs has a price — reduced and shared control over the audit and litigation.<sup>119</sup> At first glance, the IRS's and taxpayers' simplification benefits appear substantial and led one commentator to conclude that “[o]bviously, the unified audit procedures represent a vast

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112. *Id.*

113. See INTERNAL REVENUE MANUAL § 4.31.1.2(1)(H), [http://www.irs.gov/irm/part4/irm\\_04-031-001.html](http://www.irs.gov/irm/part4/irm_04-031-001.html) (defining the TMP as “[t]he designated partner to whom the Service looks as the primary representative of the partnership that is subject to a TEFRA proceeding”); see also Bakarich, *supra* note 43, at 38–39 (observing that the Treasury regulations do not require anyone to tell the non-TMP partners about routine discussions between the IRS and the TMP during the audit).

114. I.R.C. § 6224(c)(3). The IRS auditors will not even request a settlement by the TMP in his capacity as the TMP unless the partnership under audit has small partners. IRS, INTERNAL REVENUE MANUAL § 4.31.2.2.8(2), [http://www.irs.gov/irm/part4/irm\\_04-031-002.html](http://www.irs.gov/irm/part4/irm_04-031-002.html).

115. See *supra* note 26 (relating the conventional wisdom on the causes of the IRS's and taxpayers' anti-settlement stances).

116. See *supra* notes 75–79 and accompanying text (explaining how this consolidation is accomplished).

117. See *supra* notes 27–29 and accompanying text (reviewing the IRS's exposure to multiple litigations involving the same partnership issue in the U.S. Tax Court, the U.S. District Courts, and the Court of Claims).

118. See AM. LAW INST., *supra* note 9, at 15 (invoking the “great duplication of effort and coordination problems on the part of . . . taxpayers' representatives,” which can only translate into large fees, as a partial justification for adopting rules like the TEFRA partnership audit rules).

119. See, e.g., *supra* notes 60–62 and accompanying text (explaining how the TMP can extend other partners' limitations periods without consulting them).

improvement over prior law” when discussing their application to a large limited partnership tax shelter like the ones that provided the impetus for their enactment.<sup>120</sup>

But those apparent benefits are less than they seem at first blush. For both the IRS and taxpayers, the streamlined audit’s simplification benefits are undercut by the need for complex procedures to avoid trampling on each partner’s traditional right to control resolution of that partner’s tax liability. Maintaining those rights, which were a critical concern of the practitioner community when the new partnership audit rules were formulated,<sup>121</sup> shifts the focus from the partnership as an entity to the partners as individuals at several points during the audit. In each case, treating the partnership as a pure entity would have resulted in a simpler audit process for both the IRS and the partners. Congress’s decision to juxtapose the two contradictory approaches necessarily complicates that process.<sup>122</sup> Examples include (i) the notice provisions requiring that all partners (other than the small partners) receive notice of key audit events,<sup>123</sup> (ii) each partner’s right to participate in all aspects of the audit,<sup>124</sup> (iii) each partner’s right to individually settle that partner’s tax treatment of the partnership items under audit,<sup>125</sup> and (iv) the right of each partner (other than a small partner) to challenge the IRS’s FPAA in court.<sup>126</sup> Because of these procedural requirements, even though the IRS officially audits the partnership it still must track many aspects of that audit at the partner level and cannot entirely avoid the resulting duplication of effort. Furthermore, they open the door for motivated partners, acting in concert, to use mass participation in the audit and settlement proceedings as a means of impeding the audit’s progress.<sup>127</sup> While such an

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120. Darryll K. Jones, *The ‘Hoyt Fiasco,’* 112 TAX NOTES 83, 84 (2006); see *supra* Part II.A (describing the pivotal role that tax shelters conducted through large limited partnership played).

121. AM. BAR ASS’N SECTION OF TAXATION, *supra* note 7, at 551 (“The trick is to improve and facilitate the administrative and judicial process for fixing the tax liability of persons who invest in these partnerships without impairing in any significant way the traditional rights they have enjoyed as taxpayers.”).

122. See Borden, *supra* note 90, at 765 (observing that “use of the entity concept requires lawmakers to create reparative aggregate rules to remove inefficiencies and inaccuracies the entity concept creates” and that “a significant percentage of the aggregate provisions in Subchapter K are reparative provisions” — that’s complexity).

123. I.R.C. § 6223(a)(1).

124. I.R.C. § 6224(a).

125. I.R.C. § 6224(c)(1).

126. I.R.C. § 6226(a), (b)(1).

127. Coordination among the partners would be necessary because the IRS is permitted to concentrate its efforts on the TMP. See *supra* note 68 and accompanying text.

act by the partners is unlikely when their numbers are large and economic interests are small, the IRS actually anticipated high levels of partner involvement in the entity-level audit of partnerships having fewer partners.<sup>128</sup> Whether the partnership has few or many partners, widespread partner involvement negatively impacts the TEFRA partnership audit rules' simplification benefits and, in the latter case, that impact would be extreme. It is even conceivable that dealing with all the partners separately could be simpler than dealing with them as a group at one time.<sup>129</sup>

In many situations, the complicating partner-focused provisions themselves have additional layers of administrative complexity. The provision granting each partner the right to settle that partner's tax treatment of the partnership items under audit actually permits the TMP to bind the small partners under the TMP's settlement agreement if that agreement expressly states that the small partners will be bound.<sup>130</sup> But, the small partners are still not bound if they inform the IRS that the TMP does not have authority to settle disputes on their behalf at least thirty days before the day the TMP's agreement is executed.<sup>131</sup> To be effective, the statements' contents must comply with the enumerated requirements found in the Treasury regulations.<sup>132</sup> Each layer of procedural complexity further erodes the administrative simplification benefits derived from the TEFRA partnership audit rules.

Recently, the Treasury Department acknowledged that the TEFRA partnership audit rules actually "generate complex and burdensome procedural issues that do not contribute to the determination of the [partners'] tax liabilities" when the IRS uses them to audit more recent tax shelters.<sup>133</sup> For that reason, Treasury concluded that in those cases the rules

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128. See PRESIDENT'S 1978 TAX PROPOSALS, *supra* note 34, at 5836 (statement of Jerome Kurtz, Commissioner of Internal Revenue) ("An agent will go in, audit the partnership, the 4 or 5 partners are all in the same district, all participate in the audit and all sit around the table and resolve the issue."). Of course, many of these smaller partnerships ended up not being covered by the TEFRA partnership audit procedures anyway. See *infra* notes 303–310 and accompanying text (discussing the exception for many partnerships with ten or fewer partners).

129. Worley, *supra* note 32, at 22–23; John B. Palmer III, *How the TEFRA Partnership Procedures Affect Partners' Adjustments and Limitations*, 59 J. TAX'N 74, 77 (1983).

130. I.R.C. § 6224(c)(3)(A).

131. I.R.C. § 6224(c)(3)(B); Treas. Reg. § 301.6224(c)-1(a)(2).

132. Treas. Reg. § 301.6224(c)-1(c)(1).

133. Tax Avoidance Transactions, 74 Fed. Reg. 7205, 7206 (Feb. 13, 2009) (proposing amendments to regulations under § 6231 that allow the IRS to convert partnership items to nonpartnership items when the application of the unified partnership audit and litigation procedures of §§ 6221 through 6234 with respect to

“consume significant administrative resources” and “place an unnecessary burden on taxpayers, the IRS, and the federal courts.”<sup>134</sup> The proposed Treasury regulation that addresses these concerns does so by exercising Treasury’s authority to bypass the TEFRA partnership audit rules when “special enforcement considerations” that “interfere with the effective and efficient enforcement” of the Code are present.<sup>135</sup> Specifically, the proposed regulation would permit the IRS to selectively recharacterize partnership items into nonpartnership items on a “partnership-by-partnership and partner-by-partner basis” when those partnership items “relate to a listed transaction, as defined in [Treas. Reg.] § 1.6011-4.”<sup>136</sup>

The characteristics that cause the TEFRA partnership audit rules to backfire when applied to modern tax shelters are not unique to those transactions. According to the IRS, these transactions “use[] combinations of trusts, S corporations, limited liability companies, partnerships, and other entities, many times arranged in tiers, for the tax benefit of a single investor or a small group of investors.”<sup>137</sup> Under the TEFRA partnership audit rules, “[t]wo or more separate partnership proceedings, as well as a partner-level proceeding, may need to take place before an assessment can be made against the individual.”<sup>138</sup> In a nutshell, the IRS’s complaint is that, even though a modern tax shelter only involves a small number of taxpayers, the IRS cannot use the small partnership exception to bypass the TEFRA partnership audit rules and proceed directly against the taxpayer ultimately purchasing the tax shelter benefits because the shelter’s multi-tiered arrangement invariably involves impermissible types of partners that

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certain tax avoidance transactions interferes with the effective and efficient enforcement of the internal revenue laws).

134. *Id.*

135. I.R.C. § 6231(c)(1)(E), (c)(2).

136. Prop. Treas. Reg. § 301.6231(c)-9(a) (Feb. 13, 2009). The IRS formally designates a tax avoidance transaction as a listed transaction by identifying it as such in a “notice, regulation, or other form of published guidance.” Treas. Reg. § 1.6011-4(b)(2). The IRS periodically publishes a comprehensive list of these transactions, e.g., Notice 2009-59, 2009-31 I.R.B. 170, and maintains a real-time version on its website, Recognized Abusive and Listed Transactions – LMSB Tier 1 Issues, <http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html>.

137. Tax Avoidance Transactions, 74 Fed. Reg. 7205, 7206 (Feb. 13, 2009). Note that use of tiered partnerships and other pass-through entities in tax shelters during the 1970s was one of the problems that the Treasury Department raised when arguing for the shift to partnership-level tax reviews. DEP’T OF THE TREASURY, *supra* note 6, at 125–29. Of course, those earlier tax shelter promoters used limited partnerships to distribute tax savings to large numbers of investors. See *supra* Part II.A (describing how the use of large, tiered limited partnerships hampered the IRS’s ability to pursue tax shelter investors in the 1970s and early 1980s).

138. Tax Avoidance Transactions, 74 Fed. Reg. 7205, 7206 (Feb. 13, 2009).



invalidate that exception (e.g., partnership, S corporations, and trusts).<sup>139</sup> Thus, any investment structure involving (1) a partnership, (2) a small number of taxpaying investors, and (3) at least one impermissible partner should create similar problems for the IRS. Structures matching those parameters are not limited to the listed transactions that are singled out for special treatment in the proposed regulations. In fact, such structures are commonly proposed by tax advisors in areas like small business planning and estate tax planning.<sup>140</sup> The Treasury Department's conclusion that the TEFRA partnership audit rules "often result[] in multiple proceedings that complicate the ultimate determination of the investors' tax liabilities"<sup>141</sup> when applied to investment structures of this sort demonstrates that those rules can actually be counterproductive from a procedural simplification standpoint when applied outside the context for which they were originally conceived (i.e., large, syndicated tax shelter partnerships).<sup>142</sup>

Another factor to consider when weighing these administrative simplification efforts is whether they represent an actual reduction of procedural complexity or are simply the result of burden shifting among the audit participants. A mere shift of responsibility from the IRS to the partners does not affect overall procedural complexity and is only a net benefit to the group if the partners can deal with that complexity more efficiently than the IRS. In many situations that won't be the case because, as an almost continuous audit participant, the IRS's familiarity with the procedural complexity involved in an audit will be superior to that of the partners, many of whom will only experience a handful of audits throughout their lives. Through steady exposure, the IRS can be expected to have a greater awareness of, and better mechanisms for dealing with, the audit's procedural complexity. The one place where the partners would likely have an advantage over the IRS is when access to partnership/partner-specific information is relevant. In that circumstance, the partners' information advantage could create efficiency gains that benefit the IRS and the partners as a group despite the fact that there is no overall reduction in procedural complexity.

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139. See *infra* note 303 and accompanying text (explaining how the small partnership exception depends on the types of partners involved).

140. See, e.g., *Estate of Shurtz v. Comm'r*, 99 T.C.M. (CCH) 1096, 1097–1100 (2010) (recounting how a family engaged in the timber business created two tiers of limited partnerships that were partially owned by trusts based on legal advice regarding estate tax and liability exposure minimization).

141. Tax Avoidance Transactions, 74 Fed. Reg. 7205, 7206 (Feb. 13, 2009).

142. See DEP'T OF THE TREASURY, *supra* note 6, at 123 ("The large number of partners involved in syndicated, and often interrelated, tax shelter partnerships makes [IRS] efforts to ensure compliance with the tax laws extremely difficult under existing administrative and judicial procedures.").

Burden shifting from the IRS to the partners occurs in several places within the TEFRA partnership audit rules and is connected to some of the IRS's most important administrative simplification objectives involving partner notice, the limitations period, and the elimination of duplicative judicial proceedings.<sup>143</sup> In the most significant instance, the burden lands on the TMP. Because the IRS no longer deals with the partners directly on partnership issues, the TMP is charged with "keep[ing] each partner informed of all administrative and judicial proceedings for the adjustment at the partnership level of partnership items."<sup>144</sup> The TMP's duty extends to providing notice of the partnership audit's beginning and ending to the small partners,<sup>145</sup> and to notifying all partners of critical steps during the audit (e.g., the closing conference, the appeals conference, and consent to a limitations period extension affecting all partners).<sup>146</sup> These provisions do not reduce the procedural complexity involved in the audit because, with or without them, all partners in the partnership were entitled to some form of notice of these events.<sup>147</sup> Instead, they transfer some of the responsibility for dealing with that complexity from the IRS to the TMP. Because there is no change in overall procedural complexity, the provisions' net benefit to the IRS and partners turns on whether the partners are better equipped than the IRS to deal with that complexity. Unfortunately, they are not. The only partnership/partner-specific information involved is the names and addresses of the partners, all of which are required to be included in the partnership's

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143. PRESIDENT'S 1978 TAX PROPOSALS, *supra* note 34, at 5829, 5831-32 (statement of Jerome Kurtz, Commissioner of Internal Revenue) (outlining the IRS's pre-TEFRA difficulties keeping the partners' individual limitations periods open until the partnership audit was complete, the substantial burden on the IRS to locate and notify each of the partners, and the IRS's exposure to "multiple litigation, perhaps in different courts, involving the identical partnership issues").

144. I.R.C. § 6223(g). A similar duty falls to the TMP of a partnership that is a partner in the partnership being audited. I.R.C. § 6223(h)(2). That TMP must forward any notice received regarding the audit to the partners of the TMP's partnership. *Id.*; Treas. Reg. § 301.6223(h)-1.

145. Treas. Reg. § 301.6223(g)-1(a)(1)-(2).

146. Treas. Reg. § 301.6223(g)-1(b)(1)(i), (iii), (v). Other notice-worthy events include "[p]roposed adjustments, rights of appeal, and requirements for filing a protest;" "[a]cceptance by the [IRS] of any settlement offer;" and "[f]iling by the [TMP] or any other partner of any petition for judicial review." Treas. Reg. § 301.6223(g)-1(b)(1)(ii), (iv), (vii).

147. Some have observed that the partners' post-TEFRA right to notice from the TMP is pretty flimsy because the statute created no enforcement mechanism when the TMP fails to perform the duties imposed by the statute. *See, e.g., Rosen, supra* note 32, at 495-96 (expressing concern over the important responsibilities entrusted to the TMP).

information returns.<sup>148</sup> As a repeat participant and the source of the regulations governing when notice to the partners is required, the IRS is much more familiar with those rules and already has elaborate procedures in place to ensure notice is provided in analogous situations (e.g., notice to the partners in non-TEFRA partnership audits).<sup>149</sup> Therefore, this burden shifting from the IRS to the TMP should not improve overall audit efficiency and may create more fundamental problems if the TMP fails to carry out the delegated duties through incompetence or intentional misleading of the other partners.<sup>150</sup>

The second significant burden shifting created by the TEFRA partnership audit rules involves the partners' limitations periods. Unlike the notice provisions discussed above, TEFRA's adjustment to the partners' limitations periods is not a pure transfer of procedural responsibilities from the IRS to the partners. Instead, the IRS's burden of tracking each partner's limitations period was reduced by creation of a minimum partnership limitations period that in many cases relieves the IRS from needing to consider the partners' individual limitations periods.<sup>151</sup> The cost to the partners is the need to track multiple limitations periods. At minimum, a partner will have two potentially applicable limitations periods for a given tax year.<sup>152</sup> If the partner invests in multiple TEFRA partnerships, then the number of relevant limitations periods that the partner must keep track of increases arithmetically.<sup>153</sup> Clearly, the IRS's administrative simplification benefits derived from the limitations period changes are at least partially

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148. I.R.C. § 6031(a).

149. See IRS, INTERNAL REVENUE MANUAL § 4.31.5, [http://www.irs.gov/irm/part4/irm\\_04-031-005.html](http://www.irs.gov/irm/part4/irm_04-031-005.html) (containing field office procedures for non-TEFRA examinations of pass-through entities like partnerships).

150. See Jones, *supra* note 120, at 84–85 (discussing the fallout from a TMP's decision to extend the other partners' limitations period without notifying them of that extension as part of the TMP's attempt to cover up fraud). While the IRS is not above incompetence, presumably it has no reason to intentionally mislead the partners during the notice process.

151. I.R.C. § 6229(a).

152. See I.R.C. §§ 6229(a) (imposing a minimum limitations period for partnership items that can extend beyond expiration of the partners' individual limitations periods), 6501(a) (establishing the normal three-year limitations period for the partners' tax returns).

153. See I.R.C. § 6229(a)(1) (attaching each partnership's minimum limitations period to the filing of that partnership's information return); see also MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 8.17 (2003) (“[I]n addition to the examination of the taxpayer's return, the taxpayer can have TEFRA proceedings pending in different levels within the [IRS] with statutes of limitations on assessment expiring at different times as well as judicial proceedings in different courts with still other timetables.”).

offset by the additional complexity foisted on the partners and must be discounted accordingly.

A similar burden shifting situation arises in connection with the TEFRA partnership audit rules streamlining of the judicial review process. Prior to TEFRA, the IRS lamented its exposure to "multiple litigation, perhaps in different courts, involving the identical partnership issues."<sup>154</sup> That exposure was addressed by the joining of all partners into one action and the concurrent dismissal of all other actions.<sup>155</sup> Thus, in most cases the IRS only litigates a partnership issue once.<sup>156</sup> However, the cost of the IRS's streamlining benefit to the partners is exposure to the possibility of multiple litigations relating to a single tax year. Before TEFRA, each partner handled all of the partner's tax issues for a given tax year in a single judicial proceeding, regardless of whether those issues were connected to a partnership.<sup>157</sup> After TEFRA, that same partner might face two litigations if the partner disputed the IRS's tax assessments resulting from partnership issues and personal issues.<sup>158</sup> Indeed, when penalties are involved the partner often must fight that penalty assessment in a second, separate judicial proceeding even though only partnership issues are present because some of the partner's penalty defenses are personal in nature.<sup>159</sup> The partner's

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154. PRESIDENT'S 1978 TAX PROPOSALS, *supra* note 34, at 5832 (statement of Jerome Kurtz, Commissioner of Internal Revenue).

155. I.R.C. § 6226(c)(1), (b)(4).

156. Even under the TEFRA partnership audit rules, the IRS may have to litigate the same issue more than once if the issue has become a "nonpartnership item" for one or more of the partners. *See* I.R.C. § 6226(d)(1) (excluding such a partner from the group of partners who are made a party to the main partnership judicial proceeding).

157. *See* H.R. REP. NO. 97-760, at 599 (1982) (Conf. Rep.) (describing the state of the law in this area prior to TEFRA), *as reprinted in* 1982 U.S.C.C.A.N. 1190, 1371.

158. *See* I.R.C. §§ 6226(c)(1) (making the partner a party to the partnership proceeding), 6213(a) (permitting a partner to request judicial review of the IRS's notice of deficiency, which results from an audit of the partner's personal tax issues).

159. Only "the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item" is itself a partnership item covered by the TEFRA partnership audit rules. I.R.C. § 6221. While some of the legal and factual determinations necessary to apply penalties are partnership-level determinations, Treas. Reg. § 301.6221-1(c), "those that are personal to the partner or are dependent upon the partner's separate return and cannot be determined at the partnership level" are excluded from the partnership's judicial proceeding and "can only be asserted through refund actions following assessment and payment." Treas. Reg. § 301.6221-1(d), (c). Many hard-fought battles have raged along the line between partnership- and partner-level determinations in penalty situations. *See, e.g.,* Stobie Creek Invs. LLC v. U.S., 608 F.3d 1366, 1380-81 (Fed. Cir. 2010) (holding

exposure to multiple litigations for a given tax year increases with each TEFRA partnership that the partner owns.<sup>160</sup> As with the limitations period streamlining discussed above, the overall value of the IRS's simplification benefits is diminished when this cost to the partners is factored in.

When the TEFRA partnership audit rules were enacted in 1982, the IRS, the partners, and the courts hoped that the improved procedural simplicity achieved through streamlined, entity-focused partnership audits would produce significant benefits. Many of those benefits have been realized, particularly by the IRS. However, the transition to entity-focused partnership audits was not without new costs. The preservation of the partners' traditional rights after that transition required the creation of complex administrative procedures that partially offset the simplification gains achieved by the IRS and the partners. In a number of cases, the purported simplification efforts are nothing more than burden shifting from the IRS to the TMP and other partners. Due to the nature of these shifted burdens, they are not likely to improve the overall audit efficiency and may actually make it worse. In light of these countervailing forces, at best the TEFRA partnership audit rules are a modest success from a procedural simplification perspective.

*b. Rules Simplicity: A Heavy Toll*

The same cannot be said when rules, or outcome, simplicity is considered. Superficially, the TEFRA partnership audit rules added thirteen sections to the Code that, in turn, generated more than fifty Treasury regulations without eliminating any pre-existing statutory provisions.<sup>161</sup> While it should be no surprise that the addition of these new provisions created uncertainty as to their meaning and interaction with the Code's other audit procedures, the fact that litigation regarding those points persists more than twenty-five years after TEFRA and shows no signs of abating is surprising. The TEFRA partnership audit rules' negative effect on rules simplicity is a heavy toll to pay for the marginal procedural simplification benefits discussed above.<sup>162</sup>

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that the trial court in the partnership-level proceeding had jurisdiction to decide the applicability of penalties in the case because no partner-level defenses were raised).

160. See SALTZMAN, *supra* note 153, at ¶ 8.17 ("If the taxpayer is a partner in more than one TEFRA partnership, a final determination of the taxpayer owes [sic] for a year cannot be made until all the TEFRA partnership proceedings have been concluded.").

161. See *supra* note 102; see also Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §402, 96 Stat. 324, 648-69 (creating the first twelve Code sections and removing none).

162. See MICHAEL I. SALTZMAN, *supra* note 153, at ¶ 8.17 ("Once particular problems take the practitioner beyond general principles, there seems to be

One of the most prevalent sources of rules complexity resulting from the TEFRA partnership audit rules is the need to define the boundary between the main audit regime, which applies to the partners' tax issues arising outside the partnership context, and the special TEFRA partnership audit regime.<sup>163</sup> This legal classification issue is vitally important because the IRS's ability to assess additional taxes against the partner is often at stake. Typically, a partner contests whether a particular issue is a partnership item governed by the TEFRA partnership audit rules when the partner's individual limitations periods has expired but the IRS, acting on its belief that the tax resulted from a partnership item, relies on an unexpired partnership limitations period to pursue the partner under those rules.<sup>164</sup>

The basic contours of the boundary between the TEFRA partnership audit rules and the main audit regime applicable to the partners as individuals are defined by the term "partnership item."<sup>165</sup> Partnership items are those items from the relevant taxable year that Treasury regulations indicate are "more appropriately determined at the partnership level than at the partner level."<sup>166</sup> While it may seem logical to allocate an item based on where it is "more appropriately determined," that fuzzy formulation fails to provide much guidance once a partner's dispute with the IRS strays beyond the obvious items listed in the Treasury regulations.<sup>167</sup> Consequently, litigation in this area started shortly after adoption of the TEFRA partnership audit rules and persists today.

*Maxwell v. Commissioner* was the first significant case addressing the partnership item boundary.<sup>168</sup> Maxwell was a partner in a partnership that

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a maze of specific rules, which despite their specificity, leave many questions unaddressed or provide inadequate guidance.").

163. See I.R.C. §§ 6211(a), 6221.

164. See, e.g., *RJT Invs. X, LLC v. Comm'r*, 491 F.3d 732, 734–35 (8th Cir. 2007) (considering whether the shamming of a partnership was a partnership item that could still lead to a tax assessment after the expiration of the partner's individual limitations period); *Blonien v. Comm'r*, 118 T.C. 541, 542 (2002) ("Petitioners allege assessment is barred by the 3-year period of limitations provided in section 6501(a) because Mr. Blonien was not a partner of Finley Kumble subject to the alternative period of limitations provided by section 6229 for the assessment of partnership and affected items." (footnote omitted)); see also *supra* note 104.

165. See I.R.C. § 6221 (limiting application of the TEFRA partnership audit rules to "the tax treatment of any partnership item").

166. I.R.C. § 6231(a)(3).

167. Fairly uncontroversial examples provided for in the regulations include each partner's share of the partnership's income, gain, loss, deductions, credits, non-deductible expenditures, and liabilities; and the factors that underlie the determination of those amounts. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i), (a)(1)(ii), (a)(1)(v), (b)(1).

168. 87 T.C. 783 (1986).

was formed a little more than three months after the TEFRA partnership audit rules took effect.<sup>169</sup> Without completing its audit of the partnership, the IRS rejected Maxwell's claim to investment tax credits and losses flowing from the partnership in 1982, and his attempt to carry back the credits to earlier tax years.<sup>170</sup> The IRS also imposed penalties because of Maxwell's tax deficiency, including the portion attributable to the credits and losses from the partnership.<sup>171</sup> Maxwell challenged those tax and penalty assessments in an individual proceeding. After noting that the case "presents an issue of first impression arising from the application of the partnership audit and litigation provisions," the Tax Court held that it lacked jurisdiction over deficiencies and penalties resulting from the partnership's losses and tax credits in 1982 because those items were partnership items or were affected by partnership items.<sup>172</sup> As such, they could not be adjusted until after completion of the partnership-level audit.<sup>173</sup>

In the years following *Maxwell*, skirmishes along the boundary between the TEFRA partnership audit rules and the main audit regime forced the courts to classify a great variety of tax issues. To convey a sense of the frequency and extent of the steady stream of classification disputes, a partial list of issues addressed follows. A statute of limitations defense based on the FPAA,<sup>174</sup> whether the person the IRS treated as TMP was actually the TMP and therefore capable of extending the partnership's limitations period,<sup>175</sup> whether the partnership had a profit motive for its activities,<sup>176</sup> and the treatment of section 707(c) guaranteed payments by a partnership to a partner<sup>177</sup> were among the issues thrown into the partnership items bin. Items that were not partnership items, but were affected items, include a partner's

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169. *Id.* at 789.

170. *Id.* at 785.

171. *Id.*

172. *Id.* at 786, 790–93. Specifically, the 1982 losses and credits were partnership items and their carry back to earlier tax years were "affected items." *Id.* at 790–91; see also I.R.C. § 6231(a)(5) ("The term 'affected item' means any item to the extent such item is affected by a partnership item."). The related negligence penalties were also affected items whose determination must wait for determination of the partnership items. *Maxwell*, 87 T.C. at 792–93.

173. *Maxwell*, 87 T.C. at 793.

174. *Weiner v. United States*, 389 F.3d 152, 156–57 (5th Cir. 2004); *Chimblo v. Comm'r*, 177 F.3d 119, 125 (2d Cir. 1999); *Slovacek v. United States*, 36 Fed. Cl. 250, 256 (1996).

175. *Kaplan v. United States*, 133 F.3d 469, 473 (7th Cir. 1998).

176. *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 550 (5th Cir. 2009); see also *Simon v. Comm'r*, 830 F.2d 499, 507 (3d Cir. 1987) (reaching the same conclusion for pre-TEFRA partnership activity).

177. *Woody v. Comm'r*, 95 T.C. 193, 200–01 (1990).

(1) basis in the partner's partnership interest,<sup>178</sup> (2) amount at risk under section 465 with respect to the partnership,<sup>179</sup> (3) treatment of partnership losses as active or passive under section 469,<sup>180</sup> (4) section 6621(c) interest assessed on a tax underpayment attributable to a partnership item,<sup>181</sup> and (5) classification of a termination payment from the partnership as a tax-exempt compensation for disability.<sup>182</sup> Finally, a partner's (1) right to a settlement consistent with the settlement reached with another partner<sup>183</sup> and (2) refund claim after entering into a settlement agreement with the IRS<sup>184</sup> were simply not partnership items at all.

Today, litigation over classifying tax issues and the TEFRA partnership audit rules' reach continues at a steady pace. Many current disputes deal with fallout from an outbreak of tax shelters in the late 1990s

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178. See *Dial USA, Inc. v. Comm'r*, 95 T.C. 1, 6-7 (1990) (finding that, under rules for subchapter S corporations that were analogous to the TEFRA partnership audit rules, while a shareholder's basis was affected by subchapter S items, it was not itself a subchapter S item because it could depend on shareholder-level items); *Univ. Heights at Hamilton Corp. v. Comm'r*, 97 T.C. 278, 280 (1991) (acknowledging that an S corporation shareholder's basis in his shares was not a subchapter S item, but holding that the IRS could still adjust that basis indirectly by adjusting subchapter S items that affected it); see also *Treas. Reg. § 301.6231(a)(5)-1(b)* ("The basis of a partner's partnership interest is an affected item to the extent it is not a partnership item.").

179. *Roberts v. Comm'r*, 94 T.C. 853, 861 (1990) (concluding that a partner's amount at risk was an affected item when determining that amount required analysis of third-party side agreements entered into by the partner); *Hambrose Leasing 1984-5 Ltd. P'ship v. Comm'r*, 99 T.C. 298 (1992) ("We conclude . . . that the determination of amounts at risk with respect to partnership liabilities personally assumed by individual partners is not a partnership item, but is an affected item . . . ."); see also *Treas. Reg. § 301.6231(a)(5)-1(c)* ("The application of the at-risk limitation under section 465 to a partner with respect to a loss incurred by a partnership is an affected item to the extent it is not a partnership item.").

180. *Estate of Quick v. Comm'r*, 110 T.C. 172, 187-88 (1998) ("We therefore conclude that the characterization of losses as either passive or nonpassive in the hands of a partner is an affected item under section 469, and we so hold."), supplemented by 110 T.C. 440 (1998); see also *Treas. Reg. § 301.6231(a)(5)-1(d)* ("The application of the passive loss rules under section 469 to a partner with respect to a loss incurred by a partnership is an affected item to the extent it is not a partnership item.").

181. *Field v. United States*, 328 F.3d 58, 59-60 (2d Cir. 2003); *Barlow v. Comm'r*, 80 T.C.M. (CCH) 632, 643 (2000), *aff'd*, 301 F.3d 714 (6th Cir. 2002).

182. *Jenkins v. Comm'r*, 102 T.C. 550, 554-57 (1994).

183. *Monti v. United States*, 223 F.3d 76, 82-83 (2d Cir. 2000); *Prochorenko v. United States*, 243 F.3d 1359, 1363 (Fed. Cir. 2001).

184. *Alexander v. United States*, 44 F.3d 328, 331 (5th Cir. 1995).



and early 2000s that utilized partnerships.<sup>185</sup> In *Petaluma FX Partners, LLC v. Commissioner*,<sup>186</sup> the D.C. Circuit addressed whether the validity of a partnership was a partnership item. The IRS asserted in its FPAA that the partnership used in the tax shelter was a sham whose existence must be disregarded for tax purposes.<sup>187</sup> After satisfying itself that the metaphysical aspects of the question (e.g., if there is no partnership, how could there be a partnership proceeding or partnership item?) were suitably addressed by Congress and the Treasury Department,<sup>188</sup> the court found that the determination of whether a partnership existed was a partnership item.<sup>189</sup> The dispute continues, with one lower court already citing *Petaluma* while addressing the same issue.<sup>190</sup>

In addition to considering how to handle whether the partnership itself is invalid, courts have recently undertaken classification of two related items: whether a valid partnership's specific transaction is an invalid sham that can be disregarded and whether a partner listed on the partnership's tax return is the true partner. The former issue was classified as a partnership item that must be handled at the partnership level under the TEFRA partnership audit rules by the Federal Circuit during 2009 in *Keener v. United States*,<sup>191</sup> which cited a laundry list of different courts that considered the issue over the preceding 14 years. Classification of the latter issue has divided the courts in recent years. The Tax Court<sup>192</sup> and the Court of Federal

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185. Richard M. Lipton et al., *Courts Interpret the TEFRA Audit Rules on the Statute of Limitations and Partnership Items*, 107 J. TAX'N 286, 286 (2007). The author discussed one of these partnership-based tax shelters in detail, and the impact that it and other tax shelters entered into around the same time had on penalty protection issues, in Peter A. Prescott, *Taxpayer Civil Penalty Protection: Long Term Capital Holdings and Its Wake*, 81 TEMPLE L. REV. 995 (2008).

186. 591 F.3d 649, 653 (D.C. Cir. 2010); see also *RJT Invs. X, LLC v. Comm'r*, 491 F.3d 732, 737–38 (8th Cir. 2007) (same).

187. 591 F.3d at 651.

188. *Id.* at 652 (relying on I.R.C. § 6233 and Temp. Treas. Reg. § 301.6233-1T(a)).

189. *Id.* at 653–54; see also *LKF X Invs., LLC v. United States*, 2010–1 U.S. Tax Cas. (CCH) ¶ 50,488, at 85,001–28 (D.C. Cir. 2010) (per curiam) (“The Tax Court’s decision that it had jurisdiction to determine whether the partnership at issue in this case should be disregarded for federal tax purposes is affirmed.”).

190. *Fidelity Intern. Currency Advisor A Fund, LLC v. United States*, 747 F. Supp. 2d 49, 225 (D. Mass. 2010).

191. 551 F.3d 1358, 1365–66 (Fed. Cir. 2009) (citing, *inter alia*, *Nault v. United States*, 517 F.3d 2, 8 (1st Cir. 2008) and *Randell v. United States*, 64 F.3d 101, 107–08 (2d Cir. 1995)).

192. *Grigoraci v. Comm'r*, 84 T.C.M. (CCH) 186, 189–91 (2002) (holding that “a determination that the partners of record were not the true and actual partners is not a ‘partnership item’ under section 6221” where “resolution of the issue in this

Claims<sup>193</sup> have held that a partner's true identity — the identity of the actual beneficial owner — is not a partnership item. The Tenth Circuit reached the opposite conclusion when reviewing a Tax Court decision that divided an amount of partnership income and loss between a taxpayer and his bankruptcy estate (i.e., whether the taxpayer or his bankruptcy estate was the true partner).<sup>194</sup>

A final legal/classification issue created by the parallel TEFRA partnership audit rules and the main audit regime involves penalties. Since 1997, assessment of a penalty “which relates to an adjustment to a partnership item” has been a partnership item governed by the TEFRA partnership audit rules.<sup>195</sup> The nature or extent of the relationship between a penalty and a partnership item needed to make that penalty a partnership-level determination is not discussed in either the statute or the Treasury regulations.<sup>196</sup> In *Petaluma*, the D.C. Circuit reversed the Tax Court's conclusion that a penalty indirectly resulting from the Tax Court's determination that a partnership should be disregarded was sufficient to make the penalty a partnership-level determination.<sup>197</sup> The D.C. Circuit noted that the taxpayer's underpayment of tax directly related to the taxpayer's claim of outside basis in the disregarded partnership, which was an affected item, and questioned whether resolution of “affected-items questions concerning outside bases” at the partner level were needed.<sup>198</sup> The Federal Circuit relied on *Petaluma* to reach the same conclusion in *Jade Trading, LLC v. United States*.<sup>199</sup> Because the *Petaluma* and *Jade Trading*

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case does not change the number of partners, their allocable shares, or in any way affect the partnership or the other partners”); see also *Hang v. Comm'r*, 95 T.C. 74, 81–82 (1990) (ruling that a S corporation shareholder's identity not a subchapter S item under the S corporation analog to the TEFRA partnership audit rules). *But see* *Blonien v. Comm'r*, 118 T.C. 541, 551–52 (2002) (finding that a taxpayer's claim that he was not a partner at all was a partnership item when deciding that claim “would affect the distributive shares of the other partners”).

193. *Alpha I L.P. v. United States*, 84 Fed. Cl. 209, 221–22 (2008) (concluding that a partner's true identity was neither a partnership nor an affected item), *withdrawn in part*, 86 Fed. Cl. 126 (2009) (deciding that the court lacked jurisdiction to decide affected item status).

194. *Katz v. Comm'r*, 335 F.3d 1121, 1128–29 (10th Cir. 2003).

195. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1238(a), 111 Stat. 788, 1026.

196. I.R.C. § 6221; Treas. Reg. § 301.6221-1(c). Notably, partner-level defenses (e.g., whether the partner had reasonable cause for taking a particular position) are not partnership items. Treas. Reg. § 301.6221-1(d).

197. *Petaluma FX Partners, LLC v. Comm'r*, 591 F.3d 649, 655 (D.C. Cir. 2010).

198. *Id.* at 655–56.

199. 598 F.3d 1372, 1379–80 (Fed. Cir. 2010).

courts did not automatically conclude that the penalty was not a partnership item because of the intermediate step involving an affected item, but instead focused on whether additional partner-level determinations might be needed, its analysis implies that penalties based on adjustments of affected items could be partnership-level determinations. Just how far that relationship can be stretched remains to be seen and will undoubtedly be a source of significant future litigation involving the TEFRA partnership audit rules.

More mundane statutory interpretation problems have also contributed to diminished rules simplicity. Without question, the most litigious interpretation issue involves the interaction between the partnership's and the partner's limitations periods in sections 6229(a) and 6501(a), respectively.<sup>200</sup> While the courts have consistently held that the partnership's limitation period under section 6229(a) is only a minimum period for assessing additional tax resulting from the adjustment of partnership items and does not prevent later assessment if the partner's section 6501(a) limitations period has not expired, that issue alone caused Prof. Darryll Jones in 2006 to "wonder how much section 6229 has cost us so far. . . . Consider the hours expended by partners, examining agents, accountants and attorneys, law professors, committee staffers, clerks, and judges who were obliged to determine section 6229's correct meaning. Ten thousand hours and \$100 million is probably an understatement."<sup>201</sup> Since 2006, this statutory interpretation issue has been addressed by the Federal Circuit,<sup>202</sup> the Fifth Circuit,<sup>203</sup> and, undoubtedly, countless taxpayers and their advisors. Whether taxpayers will continue to try the issue in other circuits remains to be seen.<sup>204</sup>

A second statutory interpretation issue has developed in recent years involving the TEFRA partnership audit rules' scope. Various courts have had to determine whether a partnership can assert a partnership-level section 6664(c) reasonable cause and good faith penalty defense (based on the activities on the managing partners) or whether that defense is one that can only be raised by a partner in a partner-level proceeding.<sup>205</sup> To date, the Tax

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200. See *supra* note 59 and accompanying text (describing the statute of limitations controversy that has been the most litigated, and significant, statutory interpretation issue in this area).

201. Jones, *supra* note 59, at 683.

202. AD Global Fund, LLC v. United States, 481 F.3d 1351, 1354–55 (Fed. Cir. 2007).

203. Curr-Spec Partners L.P. v. Comm'r, 579 F.3d 391, 396–97 (5th Cir. 2009), *cert. denied*, 130 S. Ct. 3321 (2010).

204. The D.C. Circuit is only other circuit court to take a position on the issue. Andantech L.L.C. v. Comm'r, 331 F.3d 972, 976–78 (D.C. Cir. 2003).

205. This defense protects against civil accuracy-related and fraud penalties on "any portion of an underpayment if it is shown that there was a reasonable cause

Court,<sup>206</sup> the Fifth Circuit,<sup>207</sup> the Seventh Circuit,<sup>208</sup> and the Federal Circuit<sup>209</sup> have all found that separate partnership-level and partner-level defenses exist. Prior to the Federal Circuit's holding, the Court of Federal Claims had concluded that no partnership-level defense existed because the statute limited the defense to taxpayers and the partnership itself was not a taxpayer.<sup>210</sup> As with the statute of limitations statutory interpretation matter discussed above, it is not clear whether the existence of a partnership-level defense will remain a contentious issue in light of the relatively uniform position of the courts so far.

Each of these legal disputes would not have been necessary without the TEFRA partnership audit rules. Collectively, these disputes highlight a real and significant increase in rule complexity. Taxpayers and the IRS are simply not certain how to properly apply those rules in many situations. While it is true that the disputes discussed above represent sunk costs that can never be recovered, and as such should have no bearing on the decision of whether to keep the TEFRA partnership audit rules going forward, their continuous presence from 1985 to the present strongly suggests that we are not done paying the price for the rules' considerable complexity. That heavy toll must be weighed against any procedural simplification benefits attributable to the TEFRA partnership audit rules.

## 2. *Fairness Concerns*

The fairness concerns implicated by the TEFRA partnership audit rules can be grouped along two distinct dimensions — fairness to the partners and fairness among the partners. Fairness to the partners considers whether the treatment that the partners receive under those rules is equitable when compared to the treatment afforded other similarly-situated taxpayers. Fairness among the partners focuses on whether the partners in the same partnership receive equitable treatment when compared to the other partners in that partnership. Achieving the latter was one of the main goals for the

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for such portion and that the taxpayer acted in good faith with respect to such portion." I.R.C. § 6664(c)(1).

206. *Whitehead Hotel Ltd. P'ship v. Comm'r*, 131 T.C. 112, 173 (2008).

207. *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 548 (5th Cir. 2009).

208. *Am. Boat Co. v. United States*, 583 F.3d 471, 479–80 (7th Cir. 2009).

209. *Stobie Creek Invs. LLC v. U.S.*, 608 F.3d 1366, 1380–81 (Fed. Cir. 2010).

210. *Clearmeadow Invs., LLC v. United States*, 87 Fed. Cl. 509, 520–21 (2009).

TEFRA partnership audit rules.<sup>211</sup> As the discussion below will demonstrate, the TEFRA partnership audit rules come up short along both lines.

*a. Fairness to the Partners*

Taxpayers and their advisors were quite concerned that changing the rules used to resolve tax disputes involving partnership activities would unfairly deny the partners the traditional rights still enjoyed by other taxpayers.<sup>212</sup> Before the partners' treatment under the TEFRA partnership audit rule can be evaluated in any meaningful way, a suitable comparable must be identified. Given the aggregate/entity split personality imposed on tax partnerships, there are at least four main comparable candidates: (1) investors in a C corporation, which is taxed as a separate entity;<sup>213</sup> (2) investors in a S corporation, which is treated as an aggregate of its owners for most tax purposes;<sup>214</sup> (3) United States shareholders investing in a controlled foreign corporation because certain types of income from the corporation flow through to the shareholders and are reported on their tax returns;<sup>215</sup> and (4) a group of individual taxpayers independently making

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211. STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., *supra* note 6, at 268 (Comm. Print 1982) (citing "[i]nconsistent results . . . obtained for different partners with respect to the same item" as one reason for enacting the TEFRA partnership audit rules).

212. According to the ABA Section of Taxation, "[t]he trick [was] to improve and facilitate the administrative and judicial process for fixing the tax liability of persons who invest in these partnerships without impairing in any significant way the traditional rights they have enjoyed as taxpayers." AM. BAR ASS'N SECTION OF TAXATION, *supra* note 7, at 551; *see also* AM. LAW INST., *supra* note 9, at 24-36. The ABA's main concern was that "individual partners . . . be allowed to participate fully in the administrative and judicial processes; to take a position different from that of a general partner or designated partner representing the partnership; to dissent in certain important situations; and to reflect that dissent in a judicial forum which does not demand prepayment . . ." AM. BAR ASS'N SECTION OF TAXATION, *supra* note 7, at 552.

213. *See* I.R.C. § 11(a) ("A tax is hereby imposed for each taxable year on the taxable income of every corporation."). The term "C corporation" refers to Subchapter C — Corporate Distributions and Adjustments (I.R.C. §§ 301-385), which contains many of the corporate-specific tax rules, and is defined by exclusion. *See* I.R.C. § 1361(a)(2).

214. *See* I.R.C. § 1363(a) ("Except as otherwise provided in this subchapter, an S corporation shall not be subject to taxes imposed by this chapter.").

215. *See* I.R.C. §§ 951(a)(1), (b), 957(a). Each U.S. shareholder must report information about the controlled foreign corporation on Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations. I.R.C. § 6038(a)(4); Treas. Reg. § 1.6038-2(a)(2) (requiring Form 5471 from U.S. persons

similar investments without the use of a corporation, partnership, or other investment vehicle. C corporation investors are not good comparables because, unlike a partner in a partnership, they neither report the C corporation's economic activity on their individual tax returns nor pay the resulting taxes.<sup>216</sup> These fundamental differences from the tax partnership regime fully justify the fact that C corporation investors are not directly involved in any subsequent IRS audit of the C corporation and make the C corporation investors an inappropriate comparable. Deciding between the latter three potential comparables is unnecessary because all are covered by the main audit regime that applies to tax issues arising outside the partnership context.<sup>217</sup> Therefore, that regime will serve as the baseline for evaluating fairness to the partners.<sup>218</sup>

For partners who own one percent or more of a partnership (i.e., partners who are not small partners), fairness to the partners is not a major concern because the TEFRA partnership audit regime is roughly comparable to the main audit regime in many respects. Such a partner is entitled to notice of key audit events,<sup>219</sup> to participate in the audit,<sup>220</sup> to extend the partner's limitation period for the partnership,<sup>221</sup> to decide whether to settle with the IRS or challenge its position in court,<sup>222</sup> and to participate in the resulting litigation.<sup>223</sup> While each of these rights is subtly weakened under the TEFRA partnership audit rules,<sup>224</sup> the two main powers ceded by this class

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subject to section 6038 reporting). Joint reporting by multiple U.S. shareholders is permitted. Treas. Reg. § 1.6038-2(j)(1). Finally, each U.S. shareholder must be able to produce records sufficient to verify the relevant subpart F information for the controlled foreign corporation. Treas. Reg. § 1.964-3(a), (b).

216. See I.R.C. § 6012(a)(2) (requiring "[e]very corporation subject to taxation under subtitle A" to file an income tax return).

217. See I.R.C. § 6211(a). Arguably, the S corporation shareholders are the best comparable because S corporations and partnerships are simply two different "pass-through" tax regimes and, as such, share many of the same characteristics. See Walter D. Schwidetzky, *Integrating Subchapters K and S — Just Do It*, 62 TAX LAW. 749, 749 (2009) (calling for repeal of the S corporation regime to eliminate redundancy); Johnson, *supra* note 94, at 594–95 (recommending repeal of the partnership regime to eliminate redundancy).

218. Such an approach is consistent with the fairness concerns raised by taxpayers' representatives during the period shortly before TEFRA. See *supra* note 212 and accompanying text.

219. I.R.C. § 6223(a), (g).

220. I.R.C. § 6224(a).

221. I.R.C. § 6229(b)(1)(A).

222. I.R.C. § 6224(c)(1).

223. I.R.C. § 6226(c)(2).

224. For example, even though the partner is entitled to participate in the audit, the IRS and the TMP are free to select the time and place for all audit events

of partners are the absolute right to select the partner's judicial forum<sup>225</sup> and to prevent extension of the partner's limitations period with respect to the partnership.<sup>226</sup> Considering the procedural simplification objectives that drove implementation of the TEFRA partnership audit rules, preserving these two powers was probably not possible. However, the final rules muted the consequences of their loss to some extent. For example, a partner who is forced into district court or the Court of Federal Claims by another partner's petition is not required to pay the tax liability that would result from the IRS's adjustments, which is a standard requirement for a taxpayer petitioning those courts.<sup>227</sup> Thus, while partners who are not small partners do not receive the exact same treatment under the TEFRA partnership audit regime as other similarly-situated taxpayers (e.g., S corporation shareholders), that inequity is kept to a minimum and appears justifiable.

The same cannot be said for the small partners.<sup>228</sup> Under the TEFRA partnership audit rules, unless they band together with other partners owning at least five percent of the partnership, they are denied important individual rights provided to other taxpayers during the review process. Instead of being entitled to notice from the IRS of the audit's beginning and end, they are forced to rely on the TMP for notification.<sup>229</sup> That substitution is not inconsequential because a partner entitled to notice from the IRS is protected if the IRS fails to fulfill its responsibilities but a partner who is dependent on the TMP is not.<sup>230</sup> The TMP also has the power to bind the small partners

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regardless of whether the schedule precludes the partner from participating. Treas. Reg. § 301.6224(a)-1(a).

225. See I.R.C. § 6226(b)(1)-(2) (giving priority to a petition filed by the TMP and to petitions filed with the Tax Court).

226. See I.R.C. § 6229(b)(1)(B) (permitting the TMP to extend the limitations period for all partners without their consent).

227. See I.R.C. § 6226(e)(1) (limiting the requirement to deposit the additional tax liability to the partner filing the petition in the district court or Court of Federal Claims). Outside the TEFRA partnership audit regime, district courts and the Court of Federal Claims only have jurisdiction over tax refund claims. 28 U.S.C. § 1346(a)(1).

228. See *supra* note 66 and accompanying text (defining the term "small partner").

229. I.R.C. § 6223(b)(1), (g); Treas. Reg. § 301.6223(g)-1(a)(1), (2).

230. Compare I.R.C. § 6223(e) (allowing a partner who does not receive required notices from the IRS to elect either to accept the results of the TEFRA partnership audit proceeding or have the partner's treatment determined individually), with I.R.C. § 6230(f) ("The failure of the [TMP] . . . to provide any notice or perform any act required under this subchapter . . . on behalf of such partner does not affect the applicability of any proceeding or adjustment under this subchapter to such partner.").

under the TMP's settlement agreement with the IRS<sup>231</sup> and they are denied the right to petition a court to review the IRS's administrative adjustments to the partnership's tax return.<sup>232</sup> However, if the TMP or another partner entitled to file such a petition does so, the small partners are bound by the resulting judicial proceeding.<sup>233</sup> Finally, as with all partners, the TMP may extend their limitations period with regard to the partnership without their consent.<sup>234</sup> These provisions strip the small partners of many traditional rights granted to other taxpayers, putting them largely at the TMP's mercy and placing them at a serious disadvantage when compared to similarly-situated taxpayers.

In fact, the small partners' plight may be more than just unfair, it may be unconstitutional.<sup>235</sup> Although the issue of whether the IRS violates the Due Process Clause of the U.S. Constitution when it assesses additional tax against a small partner even though that partner has not received notice of the audit or the FPAA from the TMP has not received much attention since two circuit courts ruled in favor of constitutionality,<sup>236</sup> there is still room for concern because the courts' analysis may not entirely comport with the Supreme Court's due process jurisprudence.<sup>237</sup> While the specific arguments against constitutionality are beyond the scope of this Article, it is important to note that the fact that other small partners have not continued to push this

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231. I.R.C. § 6224(c)(3)(A).

232. *Energy Res., Ltd. v. Comm'r*, 91 T.C. 913, 916-17 (1988); *see also* I.R.C. § 6226(b)(1) ("If the [TMP] does not file a readjustment petition under subsection (a) with respect to any final partnership administrative adjustment, any notice partner (and any 5-percent group) may . . . file a petition . . ." (emphasis added)).

233. *See* I.R.C. § 6226(c)(1) (making all partners a party to the action).

234. *See supra* note 226.

235. *See* Don R. Spellmann, *Taxation Without Notice: Due Process and Other Notice Shortcomings with the Partnership Audit Rules*, 52 *TAX LAW* 133, 162 (1998) (finding nothing that "provide[s] a solid legal basis for holding that [the small p]artners have not been taxed in a manner that is contrary to the Due Process Clause"); Rosen, *supra* note 32, at 491 ("The partnership audit procedures may violate the rights of small partners to due process under the fifth amendment to the United States Constitution.").

236. *Kaplan v. United States*, 133 F.3d 469, 475 (7th Cir. 1998) ("Section 6223(b) provides actual — but not personal — notice to all partners in light of the common-law principle of partnership law that notice to one general partner constitutes notice to all partners."); *Walthall v. United States*, 131 F.3d 1289, 1294-95 (9th Cir. 1997) ("[W]e hold that [TEFRA] is reasonably calculated to provide sufficient notice to indirect partners such as the Walthalls.").

237. *See* Spellmann, *supra* note 235, at 157-60 (finding the holdings in *Kaplan* and *Walthall* lacking when analyzed in light of Supreme Court due process decisions regarding notice).



issue does not necessarily signal agreement by taxpayers that there is no due process violation. Most likely, taxpayers and their counsel have weighed the likelihood of success in the face of two adverse circuit court rulings, which might well require a trip to the Supreme Court, against the relatively small economic benefit resulting from success. Whether or not the TEFRA partnership audit rules notice provisions are ever found unconstitutional when applied to the small partners, these cases and the concerns they raise highlight the magnitude of the disadvantage faced by such partners when compared to other taxpayers.

The TMP's crucial role as representative of the small partners under the TEFRA partnership audit rules creates another inequity for them. Unlike other taxpayers, they are forced to cede control over resolution of a portion of their individual tax liabilities to another who may not truly represent their interests.<sup>238</sup> The closest analogy is a federal class action involving questions that are common to the class members and that predominate over individual issues.<sup>239</sup> In these actions, the litigation costs of resolving class-wide issues are reduced by allowing one member of the class to represent and bind the others.<sup>240</sup> For a class action judgment to bind the represented class members without violating those members' due process rights, the class representative must adequately represent them.<sup>241</sup> That cannot happen unless the representative and the class members have aligned interests.<sup>242</sup>

Unfortunately, the TEFRA partnership audit rules do not explicitly incorporate the aligned interests standard into the TMP requirements. Instead, the rules rely on selection mechanisms like designation in the partnership agreement or selection by general partners with majority interest,

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238. See Rosen, *supra* note 32, at 500 (recognizing that inadequate representation by the TMP closes the "door of access" to the courts on the small partners).

239. *Id.*; see also FED. R. CIV. P. 23(b)(3) (outlining the general requirements for this type of class action).

240. Rosen, *supra* note 32, at 500. The analogy is not perfect because the small partners are actually parties whether or not they choose to participate in the judicial proceeding, I.R.C. § 6226(c), but the absentee class members who choose not to directly participate in the class action are not, strictly speaking, parties and may even opt out of the class to pursue individual litigation. Phillips Petroleum Co. v. Shutts, 472 U.S. 797, 810–11 (1985) ("[A]n absent class-action plaintiff is not required to do anything. He may sit back and allow the litigation to run its course, content in knowing that there are safeguards provided for his protection. In most class actions an absent plaintiff is provided at least with an opportunity to 'opt out' of the class, and if he takes advantage of that opportunity he is removed from the litigation entirely."); FED. R. CIV. P. 23(c)(2)(B)(v).

241. *Hansberry v. Lee*, 311 U.S. 32, 42–43 (1940).

242. *Id.* at 45.

neither of which ensures alignment of interests for all partners.<sup>243</sup> The Tax Court has gone so far as to observe that “[t]he tax matters partner’s importance derives from his role as a fiduciary serving on behalf of the other partners, and ‘His personal interest, if any, is beside the point.’”<sup>244</sup>

Under the TEFRA partnership audit rules, it is not hard to imagine scenarios where the TMP may not be inclined to vigorously represent the small partners’ interests.<sup>245</sup> In particularly egregious cases, the TMP may act on their behalf while laboring under conflict of interest with them. The most prominent example of that situation involves the infamous “Hoyt Fiasco.”<sup>246</sup> Walter Jay Hoyt III was TMP for a host of large limited partnerships that purportedly operated cattle and sheep breeding businesses, but were really abusive tax shelter vehicles marketed to individuals seeking tax benefits.<sup>247</sup> Hoyt was under investigation by the Criminal Investigation Division of the IRS for his activities with respect to these shelters on and off beginning in 1984.<sup>248</sup> He was eventually convicted of conspiracy to commit fraud, mail fraud, bankruptcy fraud, and money laundering in 2001.<sup>249</sup> Along the way, he acted as TMP to extend the limitations periods for his many partnerships, exposing the small partners in those partnership to assessments of additional taxes, penalties, and interest many years after their participation in the shelters.<sup>250</sup> A number of partners in those partnerships challenged those assessments arguing that the conflict of interest created by Hoyt’s criminal investigations caused Hoyt to agree to the IRS’s requests for extensions even

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243. I.R.C. § 6231(a)(7); Treas. Reg. § 301.6231(a)(7)-1(e).

244. *Gateway Hotel Partners, LLC v. Comm’r*, 97 T.C.M. (CCH) 1668, 1670 (2009) (quoting *Computer Programs Lambda, Ltd. v. Comm’r*, 89 T.C. 198, 205 (1987)).

245. *See Rosen, supra* note 32, at 500–04 (exploring situations where the partnership tax rules could make the TMP indifferent to, or actually opposed to, the result that would be best for the other partners and noting that inadequate representation was the likely result when the TEFRA partnership audit rules were applied to the large limited partnership tax shelters they were designed to address).

246. Hoyt Fiasco: Information Center, <http://www.mindconnection.com/hoyt/index.htm>. Prof. Darryll K. Jones described the fallout from this fiasco several years ago, Jones, *supra* note 120, but it continues to roll along today. *See Drown v. Comm’r*, 100 T.C.M. (CCH) 64 (2010) (upholding penalties imposed by the IRS on partners in a Hoyt Farms cattle partnership).

247. *United States v. Martinez*, 564 F.3d 719, 723 (5th Cir. 2009).

248. *Phillips v. Comm’r*, 272 F.3d 1172, 1173–74 (9th Cir. 2002).

249. *United States v. Barnes*, No. CR 98-529-JO-04 (D. Or. Feb. 12, 2001), *affd. sub nom. United States v. Hoyt*, 47 F. App’x 834 (9th Cir. 2002); *see also United States v. Hoyt*, No. CR 98-529-4-JO, 2006 WL 1491574, at \*1 (D. Or. May 23, 2006) (recounting the procedural history of Hoyt’s criminal conviction).

250. Jones, *supra* note 120, at 86.

though doing so wasn't in the other partners' best interests.<sup>251</sup> Relying on the TMP's fiduciary duty to the other partners, the courts generally held that "a disabling conflict of interest will be shown only when the [TMP] has cause to prefer his own interests above his fiduciary duties, and the IRS knows that his actions are more than likely contrary to the wishes and interests of the limited partners."<sup>252</sup> Small partners have had mixed results under this standard,<sup>253</sup> but the successes and the efforts exerted by the rest to prove the necessary facts illustrate the small partners' vulnerability to the TMP's misdeeds and ineptness. Other similarly-situated taxpayers (e.g., S corporation shareholders) are not vulnerable in this manner because they operate under the main audit regime, not the TEFRA partnership audit rules.

The IRS's handling of participants in the widely marketed Son-of-BOSS tax shelters during the late 1990s and early 2000s provides a concrete example of how treatment of the fourth category of comparable taxpayers discussed above (i.e., a group of individual taxpayers independently making similar investments without the use of a corporation, partnership, or other investment vehicle) compares to the treatment accorded partners under the TEFRA partnership audit rules.<sup>254</sup> In the Son-of-BOSS shelters, the IRS confronted a situation where more than one thousand taxpayers undertook a series of transactions designed to achieve a certain tax outcome.<sup>255</sup> Although each taxpayer's transactions were unique, they were substantially similar to those entered into by the others.<sup>256</sup> Furthermore, most shelter participants

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251. See, e.g., *River City Ranches #1 Ltd. v. Comm'r*, 94 T.C.M. (CCH) 1, 10-11 (2007) (considering whether extensions signed by Hoyt were invalid due to a conflict of interest).

252. *Martinez*, 564 F.3d at 730.

253. See *River City Ranches #1 Ltd.*, 94 T.C.M. (CCH) at 10-11 (invalidating extensions signed by Hoyt due to a conflict of interest); *Martinez*, 564 F.3d at 734-35 (refusing to invalidate extensions signed by Hoyt); *Phillips*, 272 F.3d at 1173-74 (same); *Transpac Drilling Venture 1982-12 v. Comm'r*, 147 F.3d 221, 227-28 (2d Cir. 1998) (invalidating extensions involving a non-Hoyt partnership); *Madison Recycling Assocs. v. Comm'r*, 295 F.3d 280, 288-89 (2d Cir. 2002) (refusing to invalidate extensions involving a non-Hoyt partnership).

254. See Announcement 2004-46, 2004-1 C.B. 964 (containing the IRS's global settlement initiative for participants in the Son-of-BOSS tax shelters); see also Notice 2000-44, 2000-2 C.B. 255 (describing the Son-of-BOSS transactions); Allen Kenney, *Son-of-BOSS Settlement: Enforcement Wave of the Future?*, 106 TAX NOTES 43, 43 (2005) (quoting the IRS Chief Counsel stating that the initiative might be "a road map for future global settlement initiatives").

255. See Warren Rojas, *Son-of-BOSS Settlement Nets \$3.2 Billion for IRS*, 106 TAX NOTES 1493, 1493 (2005) (announcing that 1,165 individuals took advantage of the IRS's Son-of-BOSS settlement initiative).

256. See I.R.S. Office of Chief Counsel Notice CC-2003-020 at 1 ("The purpose of this Notice is to assist Chief Counsel attorneys in advising field personnel in the development of cases involving the type of transaction described in the second

adopted essentially identical positions on the legal issues arising from those transactions.<sup>257</sup> The result is a situation that is quite comparable to partners reporting their respective shares of the tax consequence arising from a partnership taking a single legal stance on a series of transactions by the partnership. Not surprisingly, many of same practical issues that led to the TEFRA partnership audit rules arose in the Son-of-BOSS shelter context (e.g., locating many taxpayers prior to expiration of their limitations periods, settlement barriers because of taxpayer and IRS concerns that later resolution of the issues would be more favorable than those settled on, and litigating the same legal issues in multiple courts).

Faced with the difficult task of pursuing a large number of similar, but unrelated, taxpayers, the IRS took several steps to simplify its task. First, the IRS attacked the Son-of-BOSS transactions by publicly denouncing the tax shelter and making it a “listed transaction.”<sup>258</sup> The latter step had three significant consequences: (1) the participants had to disclose their participation in the shelter to the IRS, (2) material advisors had to report their involvement and describe the shelter, and (3) material advisors had to maintain a list of taxpayer participants and turn over that list to the IRS upon request.<sup>259</sup> Each of these consequences helped the IRS locate shelter participants prior to expiration of their limitations periods. Second, the IRS announced a broad settlement initiative designed to mitigate taxpayer concerns that holdouts would get better terms.<sup>260</sup> Finally, the IRS centralized control of many aspects of the Son-of-BOSS audits to decrease the likelihood that those audits would result in unequal treatment.<sup>261</sup>

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fact pattern of Notice 2000-44, 2000-2 C.B. 255, and substantially similar transactions (referred to herein as Son of Boss transactions).”).

257. *Id.* at 3 (explaining the legal positions advanced by the promoters of the Son-of-BOSS arrangement).

258. Notice 2000-44, 2000-2 C.B. 255.

259. Treas. Reg. §§ 1.6011-4(a), (b)(2) (requiring taxpayer disclosure of listed transaction participation), 301.6111-3(a) (requiring material advisors to report listed transactions to the IRS), 301.6112-1(a), (b)(2) (requiring material advisors to furnish a list of taxpayers that the material advisor advised regarding the listed transaction to the IRS upon request). These regulations were revised after the Son-of-BOSS notice came out in 2000, but they did not change on these points. Today, there is a fourth consequence of the listed transaction designation — an increase in the maximum potential penalty for a tax underpayment from twenty percent to thirty percent if the listed transaction is not disclosed by the taxpayer. I.R.C. § 6662A(c).

260. Announcement 2004-46, 2004-1 C.B. 964.

261. *See, e.g.*, I.R.S. Office of Chief Counsel Notice CC-2003-020 at 1 (explaining the IRS’s legal positions with respect to one variation of the Son-of-BOSS tax shelter so that IRS attorneys would know how to advise field personnel during the development of their audit cases).

Arguably, the Son-of-BOSS shelter situation presented a more difficult auditing task for the IRS than trying to audit a partnership because the many shelter participants were not directly connected as co-investors. Despite that fact, the IRS's management of the shelter audits shows that the IRS can effectively handle situations like the ones the TEFRA partnership audit rules address without unfairly treating sets of taxpayers differently. Unlike the partners in a TEFRA partnership audit, the tax shelter participants were not forced to cede control over their limitations periods and over their choice of judicial forum to another.<sup>262</sup> When compared to the small partners, the tax shelter participants were much better off, retaining many more rights and significantly more control over resolution of their personal tax liabilities.<sup>263</sup>

The above discussion demonstrates that the partners' treatment under the TEFRA partnership audit rules is not equitable when compared to the treatment afforded other similarly-situated taxpayers. The rules force all partners to surrender important individual rights that are retained by other taxpayers whose investments are handled under the main audit regime. In the small partners' case, both the number and magnitude of the surrendered individual rights increase substantially and may rise to the level of unconstitutional. While the partners' loss of these rights may facilitate Congress's and the Treasury Department's goals for the TEFRA partnership audit rules, they are still costs that must be taken into account when evaluating whether the rules are still worth keeping. Furthermore, because the IRS's handling of the Son-of-BOSS shelter demonstrates that substantially accomplishing those goals is possible without limiting taxpayers' audit rights, the partners' loss should be given considerable weight.

#### *b. Fairness Among the Partners*

Improved fairness among the partners was one of the main reasons for adopting the TEFRA partnership audit rules. In particular, the Treasury Department and others wanted the partners to receive uniform, consistent tax outcomes.<sup>264</sup> Thus, the focus was on whether the partners received the same substantive tax result from the partnership's activities. But there is another type of fairness among the partners — procedural fairness — that must also be considered when evaluating whether the TEFRA partnership audit rules

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262. See *supra* notes 224–226 and accompanying text (showing how even the partners owning considerable percentages of the partnership cede these powers to the TMP).

263. See *supra* notes 228–234 and accompanying text (listing the rights and controls ceded by the small partners).

264. See *supra* note 38.

treat the partners in a partnership equally.<sup>265</sup> Both fairness aspects are explored below.

Consistent with the important role substantive (or outcome) fairness played in shaping the TEFRA partnership audit rules, those rules arguably improve substantive fairness among the partners.<sup>266</sup> They accomplish that result by shifting the audit's focus from the taxpaying partners to the tax-reporting partnership entity, with an eye toward creating a single partnership-level determination regarding the tax treatment of the partnership's activities that would apply to all partners in most cases.<sup>267</sup> However, there are several areas where the rules fall short of that goal, or even work against it.

The most common reason why a partner might receive a different tax result from the other partners in a TEFRA partnership is that the partner's share of the partnership's activities have been converted into nonpartnership items.<sup>268</sup> Such conversions are permitted in a number of circumstances. First, the IRS may convert a partner's partnership item to a nonpartnership item after that partner notifies the IRS that the partner has treated the partnership item in a manner which is inconsistent with the partnership's treatment of the item on the partnership's tax return.<sup>269</sup> Second, a partner may convert partnership items into nonpartnership items if the IRS failed to provide the partner with timely-mailed notice of the beginning of the partnership audit or the FPAA resulting from that audit.<sup>270</sup> Third, partnership items are

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265. As one might expect, substantive and procedural fairness often coincide, but not always. For example, one way to achieve substantive fairness would be for all partners to automatically receive the substantive result from the IRS's individual audit of whichever taxpayer partner the IRS happened to choose. Procedurally, the chosen partner would receive more favorable treatment than the other partners because only the chosen partner could exercise any control over the audit process.

266. *See supra* Part II.C (outlining how the specific rules act to (i) decrease partner ability to deviate from the partnership's tax positions, (ii) produce a single partnership-level determination regarding the tax treatment of the partnership's activities, and (iii) increase the likelihood that that determination will apply to all partners by employing a statute of limitations tied to the partnership, not the partners).

267. *See supra* Part II.B. Of course, significant simplification and ease of administration objectives also drove the shift from auditing the partners in the aggregate to auditing the partnership as an entity. *See supra* note 39 and accompanying text.

268. *See* I.R.C. § 6231(a)(4), (b)(1) (defining "nonpartnership item" as the opposite of "partnership item" and listing situations where "the partnership items of a partner for a partnership taxable year shall become nonpartnership items").

269. I.R.C. § 6231(b)(1)(A), (b)(2)(A)(i); Treas. Reg. § 301.6222(b)-2(a)(2).

270. I.R.C. §§ 6231(b)(1)(D), 6223(a), (e).

automatically converted to nonpartnership items when the relevant partner individually settles the tax treatment of those items with the IRS.<sup>271</sup> Finally, a request for administrative adjustment from a partner who is not the TMP converts the partnership items covered by that request into nonpartnership items if the IRS elects to do so or the IRS rejects the request and the partner appeals that rejection by filing a judicial refund claim.<sup>272</sup> With the exception of the second conversion situation, which is arguably unavoidable because without it the affected partner would be denied an opportunity to participate in resolving that partner's tax liability, these conversion situations generally arise when a partner requests individualized treatment that is similar to the treatment afforded taxpayers who are handled under the main audit regime.<sup>273</sup> Thus, these most common deviations from the TEFRA partnership audit rules' overall goal of the partners to receive uniform, consistent tax outcomes appear to be the result of a conscious decision to elevate fairness to the partners over fairness among the partners when appropriate.<sup>274</sup> While that is an understandable decision, it negatively impacts the effectiveness of the TEFRA partnership audit rules in accomplishing one of their main goals.<sup>275</sup>

The TEFRA partnership audit rules' handling of the partners' limitations period for IRS adjustment of partnership items and affected items creates another significant risk that a partner will receive different tax results from the other partners.<sup>276</sup> As noted above, the IRS generally has three years from the later of the partnerships filing date or the individual partners' filing dates to assess additional tax resulting from the adjustment of partnership items.<sup>277</sup> While that approach effectively prevents a partner from receiving unequal — presumably better — tax results because that partner's personal limitations period expired under section 6501(a) *before* the limitations

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271. I.R.C. § 6231(b)(1)(C). Because other partners are entitled to settle on the same terms, I.R.C. § 6224(c)(2), this conversion does not necessarily increase inequity among the partners.

272. See *supra* notes 84–87 and accompanying text.

273. Such taxpayers are under the main audit regime because they do business in S corporations, as sole practitioners, or through some other nonpartnership vehicle. See *supra* notes 213–227 and accompanying text (comparing how the TEFRA partnership audit rules compare to the main audit regime applicable to other taxpayers).

274. See *supra* notes 212–218 and accompanying text.

275. At least one commentator has noted that, once a partner separates from the partnership, the existence of these conversion opportunities actually makes the TEFRA partnership audit rules elective on the part of the IRS. Bakarich, *supra* note 43, at 33.

276. See *supra* notes 200–204 and accompanying text (discussing how the statutory language that created this risk led to extensive and costly litigation).

277. See *supra* note 59.

periods of the partnership and the other partners, it still permits a partner to receive unequal — presumably worse — results when that partner's section 6501(a) limitations period expires *after* those of the partnership and the other partners.<sup>278</sup> Professor Darryll Jones has observed that the former situation was the primary concern addressed in TEFRA because prior to that time “the government sometimes had variable and often insufficient amounts of *minimal* time, as measured from the filing of the partnership return, to perform its audit function.”<sup>279</sup> Nevertheless, one consequence of TEFRA's narrow focus on preventing a partner from benefiting from an early expiration of the partner's limitations period is the persisting potential for unfair treatment among the partners.<sup>280</sup> Indeed, the IRS was so concerned about “result[s that] would be inconsistent with the general TEFRA scheme of uniform treatment among partners” that it initially refused to use section 6501(a) to extend the audit period for partnership items.<sup>281</sup>

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278. For example, suppose a partnership and all partners but one file their tax returns on April 15, Year 1. Because of tax issues that have nothing to do with the partnership, the remaining partner files an extension on that date and ultimately files her tax return on October 15, Year 1. Assuming no extensions and no exceptions apply, the IRS would have until April 15, Year 4 to assess additional tax imposed with respect to partnership items on all the partners but the one who filed the extension. That partner will be exposed to additional assessments until October 15, Year 4 and, if the IRS discovers an error in the partnership's treatment of a tax item after April 15, Year 4 and before October 15, Year 4, will be the only partner adversely affected. The critical language in I.R.C. § 6229(a) is “shall not expire before the date which is 3 years after the later of — (1) the date on which the partnership return for such taxable year was filed . . . .” The courts have interpreted that language to create a minimum limitations period, tied to the filing of the partnership tax return, that can extend each partner's personal limitations period under I.R.C. § 6501(a) but does not shorten it. *E.g.*, *Curr-Spec Partners, L.P. v. Comm'r*, 579 F.3d 391, 393 (5th Cir. 2009), *cert. denied*, 130 S. Ct. 3321 (2010).

279. Jones, *supra* note 59, at 683. “The TEFRA's indisputable purpose was to provide the government a sufficient amount of *information* and *time* with which to conduct its audit function.” *Id.*

280. This gap is not purely an academic concern. Taxpayers trying to prevent assessment of additional taxes arising from partnership items after the expiration of the three year period in I.R.C. § 6229(a) have already litigated this issue in numerous circuits. *E.g.*, *AD Global Fund, LLC v. United States*, 481 F.3d 1351 (Fed. Cir. 2007); *Andantech L.L.C. v. Comm'r*, 331 F.3d 972 (D.C. Cir. 2003).

281. I.R.S. Litigation Guideline Memorandum TL-81 (Rev.) (Mar. 7, 1991), 1991 WL 1168404, *superseded*, I.R.S. Litigation Guideline Memorandum TL-81 (Rev.) (Feb. 5, 1999), 1999 WL 50721. The IRS ultimately reversed its position because it concluded that TEFRA's statutory framework demanded it. I.R.S. Litigation Guideline Memorandum TL-81 (Rev.) (Feb. 5, 1999) (noting that similar splits in the partners' limitations periods could be created when some, but not all,



With respect to procedural fairness among the partners, in numerous situations the small partners do not receive the same treatment under the TEFRA partnership audit rules as other partners. The specific provisions resulting in that disparate treatment minimize the role of the small partners during the partnership review process in order to streamline the IRS's administration of that review. For that reason, they are discussed in detail as part of this Article's critique of that streamlining.<sup>282</sup> Here, it is enough to note that the provisions create two classes of partners and that the class consisting of the small partners is procedurally disenfranchised.<sup>283</sup>

Among the small partners, an additional fairness issue exists — unequal procedural treatment when caught by “traps for the unwary” embedded in the provisions designed to preserve the partners' traditional rights — that can even result in unequal treatment within the small partner group itself.<sup>284</sup> These traps are a by-product of the procedural complexity found in those provisions. The two principal traps are (1) loss of notice rights when a small partner fails to recognize that the partner should band together with other small partners to form a notice group<sup>285</sup> and (2) loss of audit settlement authority when a small partner fails to notify the IRS that the TMP cannot bind the small partner under the TMP's settlement agreement.<sup>286</sup> Because of the complexity involved in these notice and settlement provisions,<sup>287</sup> small partners who are not well advised — either because they choose to be unrepresented or because they lack the funds to afford competent counsel — will receive different procedural treatment from the small partners who deftly side-step these traps (not to mention the other partners who are not exposed to these traps at all).<sup>288</sup> Although arguably falling into these traps should increase the likelihood that the foot-faulting small partner will receive the same substantive treatment as most other partners with respect to the partnership issues under review,<sup>289</sup> procedurally

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partners refused to extend their I.R.C. § 6229(a) minimum limitations periods), 1999 WL 50721.

282. *See supra* notes 114, 123, 126, 130–132 and accompanying text.

283. For another, more comprehensive, discussion of the small partners' fate, *see Rosen, supra* note 32.

284. *See supra* notes 121–126 and accompanying text.

285. I.R.C. § 6223(b)(1)(B).

286. I.R.C. § 6224(c)(3)(B).

287. *See supra* notes 130–132 and accompanying text.

288. Partners who are not small partners because they own more than one percent of the partnership's profits or because the partnership has 100 or fewer partners cannot lose their full notice and settlement rights. *See* I.R.C. §§ 6223(b)(1), 6224(c)(3)(A), 6231(a)(8).

289. For example, loss of settlement rights means that the small partners will be bound by the TMP's settlement entered into on their behalf. I.R.C. §

the partner is disadvantaged in comparison to them because the partner must navigate these traps.

The preceding discussion makes clear that TEFRA partnership audit rules' emphasis on improving substantive fairness among the partners has resulted in more uniform, consistent tax outcomes for the partners. However, the IRS's ability to selectively convert partnership items to nonpartnership items and the mechanism Congress employed for addressing pre-TEFRA problems with the partners' limitations periods still permit some partners to receive different substantive tax results. Furthermore, the small partners face additional procedural hurdles that undermine fairness among the partners. When fairness to the partners is also considered, the TEFRA partnership audit rules' overall success at promoting fairness is greatly diminished.

### 3. *Economic Efficiency*

In tax policy discussions, economic efficiency is evaluated by examining the extent that tax consequences distort people's economic decisions.<sup>290</sup> There are at least four different ways that the TEFRA partnership audit rules could have that distorting effect. Specifically, the rules could influence (1) a taxpayer's decision to invest in a partnership tax shelter instead of devoting the invested resources to other wealth-producing activities, (2) the taxpayers' choice of entity (e.g., partnership versus corporation) when starting their business, (3) the partners' decisions while conducting the partnership's business, and (4) the partners' decisions during the course of resolving a dispute with the IRS. While it is likely that the rules have had occasional, minor effects in each of these decision areas, there does not appear to be any evidence of significant distortions that would make economic efficiency an important consideration when deciding whether to keep the TEFRA partnership audit rules.

The first possible influence — discouraging taxpayers from engaging in wasteful tax-motivated sheltering activities through partnerships — was actually one of the Treasury Department's hoped-for benefits from the TEFRA partnership audit rules. The rules were intended to reduce the overall economic inefficiency created by those shelters by making them less

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6224(c)(3)(A). Presumably, given the central role played by the TMP in the partnership audit, other partners will join that settlement as well.

290. GRAETZ & SCHENK, *supra* note 33, at 29. Economic resources wasted on an inefficient, overly complex audit process are generally considered under the simplification/ease of administration tax policy factor. *See supra* Part III.A.1. This type of waste and its impact on small businesses was a primary concern of Rep. Barber B. Conable of New York in the Ways and Means Committee hearings during 1978. *See infra* note 304.

likely to succeed.<sup>291</sup> While it is possible that, in time, the TEFRA partnership audit rules might have contributed to that goal by removing some of the tactical benefits of sheltering activities contained in large limited partnerships, those contributions cannot be measured because substantive changes to the tax law in 1986 effectively prevented the use of such partnerships in the manner targeted by the Treasury Department.<sup>292</sup> It is worth noting that the TEFRA partnership audit rules did not discourage investors in the next wave of tax shelters from doing so through partnerships.<sup>293</sup> Indeed, in some instances those rules actually hampered IRS attempts to pursue the taxpayers involved.<sup>294</sup> Clearly, the TEFRA partnership audit rules have not significantly influenced the overall economic efficiency of our tax system by deterring (or encouraging) unproductive tax sheltering activity.

There doesn't seem to be any indication that the TEFRA partnership audit rules have significantly affected, either, the taxpayers' choice of entity decision when starting their businesses. In fact, the most significant development in area of business formations has been the rise of limited liability companies (LLCs) taxed as partnerships over the past twenty years.<sup>295</sup> During that period, the number of passthrough LLCs rose from virtually zero to approximately 1.9 million in 2008.<sup>296</sup> At the same time, the percentage of total business receipts earned in LLCs increased from zero to 7.2 percent.<sup>297</sup> While it is possible that the shift of business activity from corporations to partnerships represented by these numbers would have been significantly different in the absence of the TEFRA partnership audit rules, that result seems unlikely. What is clear is that the rules have not strongly deterred taxpayers from choosing tax partnerships. It is hard to imagine how

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291. *See supra* note 36 and accompanying text.

292. *See infra* notes 324–332 and accompanying text (describing the impact that the passive activity limitations had on the viability of using large limited partnerships to distribute non-economic losses among large numbers of limited partners).

293. *E.g.*, Notice 2000-44, 2000-2 C.B. 255 (explaining and attempting to debunk the use of paired options in combination with a tax partnership to generate a substantial non-economic tax loss for one of the partnership's investors).

294. *See supra* notes 133–136 and accompanying text (noting the Treasury Department's recent attempt to remove these more recent tax shelters from the purview of the TEFRA partnership audit rules).

295. Martin A. Sullivan, *Passthroughs Shrink the Corporate Tax By \$140 Billion*, 130 TAX NOTES 987, 988 (2011).

296. *Id.* at 987.

297. *Id.* at 988.

they could have strongly encouraged taxpayers to choose tax partnerships either.<sup>298</sup>

Similarly, there is little reason to believe that the TEFRA partnership audit rules have any significant impact on the partners' decisions regarding how to conduct the partnership's day-to-day business operations. Confined as those rules are to the IRS audit and subsequent litigation, there is little chance for them to do so. Realistically, the elevation of one partner to TMP presents the most likely opportunity for those rules to affect ordinary business decisions. While the TMP's powers are typically largely limited to the confines of any IRS audit resulting from the partnership's activities,<sup>299</sup> it is possible that the partners might vest additional tax-related powers in the TMP and that the TMP might be able to use those powers to influence non-tax business decisions.<sup>300</sup> However, the Author is not aware of any examples where a TMP, solely by virtue of being the TMP, exercised authority in a manner that significantly affected partnership business decisions.

Finally, the TEFRA partnership audit rules could influence the partners' decisions during the course of resolving a dispute with the IRS. Strictly speaking, this type of distortion does not directly involve non-tax economic activity and should therefore arguably be excluded from the economic efficiency analysis. But, to the extent that those rules result in decisions that hasten or delay the dispute's resolution, they could indirectly impact the partnership's deployment of its economic resources by either hastening or delaying their availability for productive use. The key consideration here is the rules' streamlining effect on the audit and any subsequent litigation. As discussed in Part III.A.1 above, the TEFRA partnership audit rules did achieve a number of streamlining benefits — particularly for the IRS — that have the potential to result in considerably quicker dispute resolution for all the partners. Unfortunately, realizing those benefits depends on the IRS and the partners moving the audit forward as quickly as possible. Delays by one side or the other in carrying out the TEFRA partnership audit process (e.g., responding to inquiries and analyzing information provided) are much more likely to determine overall audit

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298. LLCs taxed as partnerships are particularly desirable because they combine the limited liability and management/ownership flexibility of a corporation with the single layer of tax of a partnership. LAURA E. CUNNINGHAM & NOËL B. CUNNINGHAM, *THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS* 4–6 (4th ed. 2011).

299. *See supra* notes 60–87 and accompanying text (outlining the audit process and the TMP's powers and duties in connection with it).

300. For example, if the partnership agreement gives the TMP exclusive power to make all tax elections for the partnership, the TMP might be able to influence whether a third party would want to purchase an interest in the partnership from an existing partner by controlling the partnership's decision to adjust its basis in its assets in connection with that purchase. *See* I.R.C. §§ 743(b), 754.

duration than the process itself. Accordingly, the rules streamlining benefits may encourage shorter IRS reviews that do not encumber partnership resources for longer than necessary, but they do not guarantee that result.

While economic efficiency was an important consideration for the Treasury Department and Congress during the period leading up to the enactment of the TEFRA partnership audit rules, there is little evidence that those rules significantly improved the overall economic efficiency of tax law as applied to partnerships. Surprisingly, due primarily to subsequent substantive tax law changes and to changes in the role partnerships played in later tax shelters, those rules had minimal impact on later taxpayers' decisions to choose partnership tax shelters over other wealth-producing activities. They also had little or no effect of other non-tax aspects of the partnership's business operations. For those reasons, economic efficiency should not be an important consideration when deciding whether to keep the TEFRA partnership audit rules.

#### *B. TEFRA's Practical Shortcomings*

However one evaluates the relative theoretical strengths and weaknesses of the TEFRA partnership audit rules, in the end their ongoing value depends on whether they continue to deliver practical benefits to the IRS and taxpayers that are sufficient to outweigh their costs. Many of these practical benefits and costs are discussed above because they are implicated by the internal structure of the rules themselves. But there are several extrinsic practical factors that should be considered. First, the exclusion of many partnerships from the TEFRA partnership audit rules diminishes the overall value of any benefits arising from them. Second, Congress made several substantive changes to the Code after passing TEFRA that effectively addressed taxpayers' use of large limited partnerships in tax shelters. Finally, since 1982 technological improvements to the IRS's communications and data management capabilities should have mitigated many of the administrative issues created by those large partnerships. Each of these considerations tends to reduce the TEFRA partnership audit rules' practical value.

##### *1. The Rules' Limited Reach*

In practice, the benefits derived from the TEFRA partnership audit rules are limited in scope because the TEFRA partnership audit rules only apply to a narrow subset of all partnerships. Generally, a TEFRA partnership is a "syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate" that is required to file an annual information

return with the IRS.<sup>301</sup> An otherwise covered unincorporated organization may avoid the TEFRA partnership audit rules, and the rest of the tax law applicable to partnerships, by electing out of partnership status if its members' income can be adequately determined without being subjected to partnership treatment and it only (1) conducts investment activities; (2) jointly produces, extracts, or used property; or (3) engages in certain short-term securities-related activities.<sup>302</sup>

More significantly, small partnerships "having 10 or fewer partners each of whom is an individual . . . , a C corporation, or an estate of a deceased partner" are not normally covered by the TEFRA partnership audit rules.<sup>303</sup> This exclusion attempts to protect traditional small partnerships, which even the Treasury Department acknowledges do not present significant auditing problems, from the TEFRA partnership audit rules.<sup>304</sup> As demonstrated by

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301. I.R.C. §§ 6231(a)(1), 6031(a), 761(a). The intricacies of sorting out whether a business entity is a partnership, corporation, or trust are the province of the so-called "check the box" regulations and are beyond the scope of this article. See Treas. Reg. §§ 301.7701-2, -3, -4 (containing the rules for classifying business entities for federal tax purposes).

302. I.R.C. § 761(a). This election out of partnership status is the ultimate in aggregate treatment because each member stands entirely on its own. A joint operating agreement to extract oil and gas is a common candidate for this election. See Martin J. McMahon, Jr., *The Availability and Effect of Election Out of Partnership Status Under Section 761(a)*, 9 VA. TAX REV. 1, 5 (1989) (labeling oil and gas joint operating agreements as the area where electing out of partnership status has the most significance); see also Treas. Reg. § 1.761-2(d) (providing "[r]ules for gas producers that produce natural gas under joint operating agreements"); Martin M. Van Brauman, *Federal Tax Considerations in Foreign Oil and Gas Operations by Domestic Oil Companies*, 9 J. NAT. RESOURCES & ENVTL. L. 31, 37-38 (1994) ("Usually, foreign joint operating agreements provide that all parties elect under section 761(a) to exclude operations from the partnership provisions and authorize the operator or other designated agent to file all necessary documents with the Internal Revenue Service for the election.").

303. I.R.C. § 6231(a)(1)(B)(i). The list of acceptable partners generally consists of persons who pay their own taxes and excludes entities that merely pass on their tax attributes to others (e.g., partnerships, S corporations, and trusts). *Id.* Layering of the latter into "multi-tiered arrangements" was much maligned by the Treasury Department prior to TEFRA. DEP'T OF THE TREASURY, *supra* note 6, at 125-29. A small partnership may elect to be covered by the TEFRA partnership audit rules. I.R.C. § 6231(a)(1)(B)(ii).

304. DEP'T OF THE TREASURY, *supra* note 6, at 123. In fact, the small partnership exception was not in the Treasury Department's initial 1978 proposal. It was likely added later in response to concerns expressed by members of Congress and practitioners that the new audit procedures' scope be limited to the actual source of the problem — large tax shelter partnerships — in order to avoid overburdening law-abiding taxpayers. See PRESIDENT'S 1978 TAX PROPOSALS, *supra* note 34, at

Table I, partnerships with ten or fewer partners represent the bulk of the entities that are treated as tax partnerships and file information returns.<sup>305</sup> The table uses the total number of active partnerships<sup>306</sup> filing information returns with the IRS in a given year and the number of partners reported on those returns to calculate the mean number of partners in a partnership for that year.<sup>307</sup> Electing large partnerships, which are partnerships with 100 or more partners that elect special treatment under the Code, are not included in the data because they are not covered by the TEFRA partnership audit rules.<sup>308</sup> As the table shows, the mean number of partners per partnership dropped roughly twenty-seven percent from 1998 to 2008 and has hovered around six for the last six years covered. Because all partnerships must have at least two partners<sup>309</sup> and can have an unlimited number on the high side,

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5836 (statement of Rep. Barber B. Conable, Member, House Comm. on Ways and Means) (“The typical partnership is a very small partnership; we shouldn’t legislate with a 5,000 partnership in mind. We would be imposing burdens on the small partnership because there are excessive examples of this sort. . . . [W]hen we go after abuses we wind up harrassing [sic] a lot of legitimate operations because of the assumption of abuse that results from a few exceptions.”); AM. BAR ASS’N SECTION OF TAXATION, *supra* note 7, at 554 (proposing rules that only apply to syndicated investment partnerships that must be registered with the Securities Exchange Commission and have at least 100 partners).

305. This statement was true prior to the TEFRA partnership audit rules. When the Treasury Department compiled data regarding the number of partnership having partners in various size ranges for the PRESIDENT’S 1978 TAX PROGRAM, found that 909,704 of the 1,073,094 partnerships filing information returns in 1975 had between two and four partners (84.8 percent). DEP’T OF THE TREASURY, *supra* note 6, at 124. Another 9.6 percent (103,434 out of 1,073,094) had between five and ten partners. *Id.*

306. For this purpose, active partnerships are defined as “those that reported any items of income or deduction derived from a trade or business, or from rental or portfolio income.” Tim Wheeler & Nina Shumofsky, *Partnership Returns, 2008*, STATISTICS OF INCOME BULLETIN, Volume 30, Number 1, at 79, 90, <http://www.irs.gov/pub/irs-soi/10fallbul.pdf>.

307. 2008 is the most recent year for which the IRS has released filing data.

308. I.R.C. § 6240(b)(1). Electing large partnerships are significantly larger than the typical partnership, averaging 302 partners per partnership in 2008. *See* Wheeler & Shumofsky, *supra* note 306, at 89 (reporting that ninety-nine partnerships filed as electing large partnership in 2008 and that they reported a total of 29,873 partners).

309. *See* Treas. Reg. § 301.7701-2(a) (“A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded . . .”).

the median is almost certainly significantly lower than six.<sup>310</sup> Thus, while the exact percentage of partnerships that are by default exempt from the TEFRA partnership audit rules because they have ten or fewer partners is not discernable from the available data, it is clear that that percentage is large. Of course, some of the partnerships with ten or fewer partners will still be TEFRA partnerships because they have disqualifying partners (e.g., another partnership as a partner).<sup>311</sup> Nevertheless, there is little question that the small partnership exception severely limits the TEFRA partnership audit rules' scope and the magnitude of any benefits derived from them.

**Table I:**  
**Estimated Partners Per Active Partnership**  
**(Excluding Electing Large Partnerships<sup>1</sup>)**

Year Information Return Filed	Active Partnerships <sup>2</sup>	Partners <sup>2</sup>	Partners/Partnership
2008	3,145,907	19,270,377	6.126
2007	3,096,234	18,480,497	5.969
2006	2,947,013	16,694,408	5.665
2005	2,763,519	16,180,343	5.855
2004	2,546,783	15,503,322	6.087
2003	2,375,273	14,054,008	5.917
2002	2,242,060	14,271,080	6.365
2001	2,132,018	14,159,703	6.641
2000	2,057,403	13,578,447	6.600
1999	1,936,819	15,893,400	8.206
1998	1,855,348	15,663,372	8.442

1: Not subject to the TEFRA partnership audit rules under IRC § 6240(b)(1).

2: Estimates from information published in the IRS Statistics of Income Bulletins (e.g., Tim Wheeler and Nina Shumofsky, Partnership Returns, 2008, Statistics of Income Bulletin, Volume 30, Number 1, at 79, 80, 89, <http://irs.gov/pub/irs-soi/10fallbul.pdf>).

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310. "Median" is defined as "[a] quantity, term, or value that is the midpoint of a set of values, such that the variable has an equal probability of falling above or below it." Oxford English Dictionary, median, n.2 and adj.2, <http://www.oed.com/view/Entry/115646?rskey=JjGnMO&result=2&isAdvanced=false#>. In contrast, "mean" means "[t]he average of a set of numerical values." Oxford English Dictionary, mean, n.3, <http://www.oed.com/view/Entry/115436?rskey=C3aJ55&result=3&isAdvanced=false#>.

311. See *supra* notes 133–139 and accompanying text (detailing recent IRS complaints about problems created by this exception to the exception).



On the upper end of the size range, the exclusion of electing large partnerships and certain publicly traded partnerships<sup>312</sup> further limits the scope and benefits of the TEFRA partnership audit rules. The former's elective exclusion is described above,<sup>313</sup> while the latter are not covered by virtue of the fact that they are treated as corporations for federal tax purposes.<sup>314</sup> The practical consequence of that corporate tax treatment for publicly traded partnerships is that few exist today,<sup>315</sup> and those that do escape corporate taxation by engaging in a limited number of permissible income-producing activities like "exploration, development, mining or production, processing, refining, transportation . . . , or the marketing of any mineral or natural resource."<sup>316</sup> Any other trade or business wishing to reach a large number of investors through public trading of its interests on a securities exchange simply incorporates.<sup>317</sup> As a result, the publicly traded partnership rules effectively cap the number of partners in nearly all partnerships and, together with the electing large partnership exclusion, emasculate the TEFRA partnership audit rules in the very size range where those audit rules should have provided the greatest benefits. Taken together, these exceptions for unincorporated organizations electing out of partnership status, small partnerships, electing large partnerships, and publicly traded

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312. A partnership is publicly traded when partnership interests "are traded on an established securities market" or "are readily tradable on a secondary market." I.R.C. § 7704(b). A publicly traded partnership is not excluded from the TEFRA partnership audit rules if ninety percent or more of the partnership's gross income for the taxable year is qualifying, mostly passive-type income. *See id.* § 7704(c)(1), (c)(2), (d)(1).

313. *See supra* note 308 and accompanying text (identifying which partnerships are electing large partnerships and the statutory basis for their exclusion from the TEFRA partnership audit rules).

314. I.R.C. § 7704(a).

315. National Association of Publicly Traded Partnerships, Currently Trading PTPs and Funds, <http://www.naptp.org/PTP101/CurrentPTPs.htm> (listing approximately 120 publicly traded partnerships).

316. I.R.C. § 7704(d)(1)(E); *see also* National Association of Publicly Traded Partnerships, Facts & Answers about Publicly Traded Partnerships, [http://www.naptp.org/Navigation/PTP101/PTP101\\_Main.htm](http://www.naptp.org/Navigation/PTP101/PTP101_Main.htm) ("Most PTPs today are in energy related businesses.").

317. The large syndicated limited partnerships used to mass market tax shelters in the 1970s and early 1980s were often registered under federal or state securities laws and offered for sale to the public. DEP'T OF THE TREASURY, *supra* note 6, at 67. The publicly traded partnership rules did not affect those tax shelters because the rules did not become part of the Code until 1987. *See Omnibus Budget Reconciliation Act of 1987*, Pub. L. No. 100-203, § 10211(a), 101 Stat. 1330, 1330-403 to 1330-405 (enacting I.R.C. § 7704).

partnerships limit the TEFRA partnership audit rules' scope and mute their impact.

## 2. Changing Circumstances

Since 1982, the circumstances that compelled Congress to enact the TEFRA partnership audit rules have changed in ways that diminish the need for those rules. As noted above, Congress's primary motive was to address procedural and fairness issues created in the 1970s and early 1980s by tax shelters implemented and mass marketed using large limited partnerships.<sup>318</sup> The TEFRA partnership audit rules attacked those limited partnership tax shelters by altering the process used to review the claimed tax benefits.<sup>319</sup> Congress continued its efforts on this front by enacting several substantive provisions designed to prevent shelter investors from claiming those benefits in the first place. On the non-legal front, access to improved communications and data management resources should aid the IRS in its efforts to effectively audit large partnerships.

The two most significant substantive changes to the tax law impacting the use of large limited partnerships in mass marketed tax shelters are the passive activity loss and credit limitations<sup>320</sup> and the creation of publicly traded partnerships.<sup>321</sup> Because the latter substantive change also served to effectively limit the reach of the TEFRA partnership audit rules, it is discussed in detail above.<sup>322</sup> It is enough to repeat here that any partnership large enough to require access to broad capital markets is taxed as a corporation instead of a partnership and that that reclassification prevents flow-through of tax items from the business (i.e., the corporation) to the owners.<sup>323</sup>

Congress enacted the passive activity limitations in 1986 as part of that year's long-awaited, comprehensive overhaul of the Code.<sup>324</sup> Those limitations were a direct response to the prevalence of mass-marketed limited

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318. See *supra* notes 6–10 and accompanying text.

319. See *supra* Part II.C (providing a brief overview of the changes).

320. I.R.C. § 469.

321. I.R.C. § 7704.

322. See *supra* notes 312–317 and accompanying text.

323. Compare I.R.C. § 11(a) (“A tax is hereby imposed for each taxable year on the taxable income of every corporation.”), with *id.* § 701 (“A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.”).

324. Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 100 Stat. 2085, 2233–41.

partnership tax shelters in the years preceding 1986,<sup>325</sup> many of which purported to allow wealthy taxpayers to reduce their tax liabilities by offsetting credits and deductions from their tax shelter investments against other income.<sup>326</sup> The passive activity limitations prevent that result by segregating the taxpayer's "passive activities" from his or her other activities, and then suspending (1) losses in excess of income and (2) credits in excess of tax resulting from those passive activities.<sup>327</sup> Subsequent excess income or tax from the passive activities frees the suspended losses and credits for use against the later excess income or tax.<sup>328</sup>

These passive activity limitations, not the TEFRA partnership audit rules, "effectively ended the . . . mass-marketed wave of tax shelters" that begat those audit rules.<sup>329</sup> By statute, a limited partner's interest in a limited partnership engaged in a trade or business is a passive activity whose deductions and credits are subject to the limitations discussed above at the partner level.<sup>330</sup> As a result, taxpayers looking to acquire tax shelter benefits through investment in the large limited partnerships previously used to mass market those benefits were denied the promised tax savings because they could not immediately use the limited partnerships' tax deductions and credits.<sup>331</sup> With the end of the abuse opportunity, the need for the TEFRA partnership audit rules to facilitate the IRS's review of large limited partnerships largely disappeared and hasn't been seen since.<sup>332</sup>

The Internal Revenue Code is not the only thing to change since the enactment of the TEFRA partnership audit rules.<sup>333</sup> The communications and

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325. See *supra* Part II.A (explaining the role these tax shelters also played in the enactment of the TEFRA partnership audit rules).

326. S. Rep. No. 99-313, at 713-14 (1986), as reprinted in 1986-3 (Vol. 3) C.B. 1, 713-14.

327. I.R.C. § 469(a), (d).

328. See *id.* § 469(b).

329. Johnson, *supra* note 94, at 602.

330. I.R.C. § 469(c)(1), (h)(2). The Treasury Department has created a limited number of exceptions to this statutory rule, none of which would normally apply to a typical tax-shelter investor. See Treas. Reg. § 1.469-5T(e)(2) (excluding limited partners who, for example, participate in the limited partnership's activities for more than 500 hours in the taxable year).

331. Robert J. Peroni, *A Policy Critique of the Section 469 Passive Activity Loss Rule*, 62 S. CAL. L. REV. 1, 3 n.12 (1988) (citing newspaper and magazine articles describing the dramatic drop in tax shelter activity after enactment of the Tax Reform Act of 1986).

332. Johnson, *supra* note 94, at 602.

333. Even before 1982, the IRS had adopted a number of procedures to improve its ability to handle large partnership audits. These improvements included (1) identifying and classifying tax shelters, (2) appointing point personnel to coordinate audits and litigation related to those shelters, and (3) developing

information management resources available to the IRS have dramatically improved as well. In 1982, the Commodore 64<sup>334</sup> and the Apple II Plus,<sup>335</sup> each of which supported up to 64 kilobytes of memory and about one MHz of processor speed, were “state of the art” desktop computers. The Internet was still a decade away from becoming a widely available tool for long-distance information sharing.<sup>336</sup> With only these relatively primitive tools available, it’s not surprising that the IRS struggled to initiate and coordinate the large number of partner audits resulting from the limited partnership tax shelters sold at that time.<sup>337</sup>

Times have changed. Today, inexpensive desktop computers typically sport hard drives with hundreds of gigabytes of memory and processor speeds in excess of two GHz.<sup>338</sup> And, of course, the Internet has ushered in the Information Age.<sup>339</sup> Likewise, information management tools far outstrip what was available in 1982. The IRS has responded to these advances by adopting several technology modernization initiatives in the intervening years.<sup>340</sup> Although the IRS has had funding difficulties that have prevented it from fully capitalizing on the enhanced technology now available,<sup>341</sup> it continues to move forward and improve.<sup>342</sup> Technology

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standardized notices, legal arguments, and settlement positions for each shelter. *Id.* at 601.

334. Wikipedia, Commodore 64, [http://en.wikipedia.org/wiki/Commodore\\_64](http://en.wikipedia.org/wiki/Commodore_64).

335. Wikipedia, Apple II Plus, [http://en.wikipedia.org/wiki/Apple\\_II\\_Plus](http://en.wikipedia.org/wiki/Apple_II_Plus). Shortly thereafter, Apple introduced the Apple IIe. A significant innovation, the Apple IIe was a “cost-reduced yet more powerful machine that used newer chips to reduce the component count and add new features, such as the display of upper and lowercase letters and a standard 64 kB of RAM.” Wikipedia, Apple II Series, [http://en.wikipedia.org/wiki/Apple\\_II\\_series](http://en.wikipedia.org/wiki/Apple_II_series).

336. Wikipedia, Internet, <http://en.wikipedia.org/wiki/Internet> (“Although the basic applications and guidelines that make the Internet possible had existed for almost two decades, the network did not gain a public face until the 1990s.”).

337. *See supra* notes 17–26 and accompanying text.

338. *See, e.g.*, Dell Desktop Computers & PCs, All-In-One Computers, <http://www.dell.com/us/p/desktops#>.

339. Wikipedia, Information Age, [http://en.wikipedia.org/wiki/Information\\_Age](http://en.wikipedia.org/wiki/Information_Age).

340. The first such plan was known as the Tax Modernization System, which was adopted in 1988 and implemented over the succeeding seven years. DEP’T OF THE TREASURY, INTERNAL REVENUE SERVICE BLUEPRINT FOR TECHNOLOGY MODERNIZATION, 1997 TAX NOTES TODAY 98-41 (May 20, 1997).

341. INTERNAL REVENUE SERVICE, IT MODERNIZATION VISION AND STRATEGY 8–9 (Oct. 2006) (describing how several of the IRS’s critical systems — notably its Master Files and Integrated Data Retrieval System — are products of the 1960s and 1970s and that it has had to carry out improvements in “a more restricted funding environment”).

modernization remains a top priority and, at present, the IRS is in the midst of developing and carrying out “a Data Strategy that includes a comprehensive plan for data collection, consolidation, storage, and distribution.”<sup>343</sup> In addition, partnerships with more than 100 partners must file electronic tax returns that facilitate efficient data entry and tracking to ensure that the partners consistently report their shares of the partnership’s income.<sup>344</sup> With the benefit of these technological improvements, the IRS should be better prepared today to cope with the administrative coordination and information management issues arising in the audits of numerous partners, spread over multiple field offices in far-flung locations, but connected by a single, large partnership.<sup>345</sup> Accordingly, the administrative simplification benefits derived from the TEFRA partnership audit rules are diminished in value. When the concurrent changes to the substantive tax provisions discussed above are also taken into account, changing

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342. J. RUSSELL GEORGE, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, MANAGEMENT AND PERFORMANCE CHALLENGES FACING THE INTERNAL REVENUE SERVICE FOR FISCAL YEAR 2010, at 2 (Oct. 15, 2009) (recognizing that the IRS Modernization Program is “a complex effort to modernize IRS technology and related business processes” and “involves integrating thousands of hardware and software components while replacing outdated technology and maintaining the current tax system” before observing that the “IRS Modernization Program has continued to help improve IRS operations”).

343. MICHAEL R. PHILLIPS, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, IMPLEMENTING THE DATA STRATEGY WILL MAKE SYSTEM AND APPLICATION DEVELOPMENT MORE EFFICIENT AND EFFECTIVE 1 (Feb. 19, 2009) (reviewing the IRS’s progress in developing and implementing its data strategy).

344. I.R.C. § 6011(e)(2). This requirement was imposed in 1997 when Congress began to heavily push electronic reporting. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1224, 111 Stat. 788, 1019.

345. One indication that Congress believes the IRS can now handle such audits, and has been able to for some time, is that in 1997 it repealed the S corporation equivalent of the TEFRA partnership audit rules. Recall that the tax consequences of the S corporation’s activities flow through to the S corporation shareholders and are individually reported by them. *See supra* notes 214–217 and accompanying text. After the 1997 law change, unlike the partners in a TEFRA partnership, each S corporation shareholder could only be separately audited on that shareholder’s reported share of the S corporation’s tax items. *See* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1307(c)(1), 110 Stat. 1755, 1781 (repealing I.R.C. § 6244 (1996), which extended the TEFRA partnership audit rules to S corporations). At the same time, Congress increased the number of shareholders an S corporation could have from 35 to 75. *Id.* at § 1301, 110 Stat. at 1777. Today, that number is 100. I.R.C. § 1361(b)(1)(A). These changes suggest that Congress thinks the IRS is capable of handling the audit of at least 100 flow-through taxpayers separately.

circumstances may have reduced the rules' value to roughly on par with that of a Commodore 64 in 2011.

#### IV. CONCLUSION

Lawyers like to say that "bad facts make bad law" when explaining wrong turns in our judicially-created common law. Unfortunately, legislatures can fall prey to that trap too. When Congress enacted the TEFRA partnership audit rules in 1982, it reacted to a perceived widespread attack on the U.S. income tax system that was made possible by the use of large limited partnerships to mass market tax shelters. Time and experience have shown that Congress's response to these bad facts was — and is — bad law.

After almost thirty years, one thing is clear. The TEFRA partnership audit rules' costs now outweigh their benefits. Those perceived benefits — elimination of the practical tax shelter problem that spurred the rules' creation and a more streamlined review process that would simplify administration and improve fairness among the partners — turned out to be unnecessary (the former) or overstated (the latter). Numerous negative tax policy consequences arose that partially offset the rules' positive procedural impact, and other changes in the substantive tax law and in the world significantly reduced the benefits derived from them.

For all these reasons, the TEFRA partnership audit rules should be repealed, leaving behind only the requirement that each partner must report the tax consequences of the partnership's activities in a manner that is consistent with the partnership's tax return, or notify the IRS of that partner's inconsistency.<sup>346</sup> Just as *Happy Days* viewers began tuning out after Fonzie literally jumped the shark,<sup>347</sup> Congress and the IRS should recognize that the TEFRA partnership audit rules have figuratively "jumped" and pull the plug.

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346. See *supra* note 4. S corporation shareholders also receive flow-through tax consequence, but they are no longer subject to something like the TEFRA partnership audit rules. See *supra* note 345. However, for the reasons discussed in footnote 4 they are still required to inform the IRS of deviations from the S corporation's tax return. I.R.C. § 6037(c).

347. See *supra* note 5 (defining "jump the shark" and detailing the phrase's *Happy Days* origin). *Happy Days*' ratings steadily declined starting with the 1977-1978 season containing the shark stunt. See Wikipedia, *Happy Days*, [http://en.wikipedia.org/wiki/Happy\\_Days](http://en.wikipedia.org/wiki/Happy_Days) (reporting the show's ratings for all eleven seasons).