REPORT # 581

TAX SECTION

New York State Bar Association

Proposed Amendments In Tax Court
Rules For Partnership Actions

Prepared by
The Committee on Partnerships
New York State Bar Association
Tax Section

April 15, 1988

Table of Contents

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April 19, 1988

Partnership Actions Rules Revisions

Dear Judge Nims:

I am pleased to forward to you the enclosed Report on the proposed changes in the Tax Court Rules for Partnership actions prepared by our Committee on Partnerships. The report was written by Stephen L. Millman and Robert S. Ocko.

The principal focus of the report is on how the proposed changes would affect partnerships in which the tax matters partner is bankrupt, dormant or actively adverse to other partners. Because of concerns about the burdens on other partners when any of those situations arise, we have recommended that the Tax Court continue to allow petitions and elections to participate in partnership actions until 210 days after the final partnership administrative adjustment was issued and to allow the tax matters partner 15 days to transmit notices of petitions. For similar reasons, we have suggested that the rules for entry of decision give less latitude to the tax matters partner. We have also noted that the Rule requiring a petitioning partner to state that he has an interest in the outcome does not work well where the partner is

claiming the statute of limitations has run as to him, and he therefore has an interest only if such claim is wrong.

Very Truly Yours,

Herbert L. Camp

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Proposed Amendments In Tax Court Rules For Partnership Actions

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Proposed Amendments in Tax Court Rules For Partnership Actions

This Report[1] contains recommendations relating to the proposed changes to the Tax Court Rules (the "Rules") for partnership actions.

Summary

Our principle recommendations are:

1. A petition to the Tax Court by a partner other than the Tax Matters Partner should not require the partner to assert that the statute of limitations has not run nor to assert that partnership items have not become nonpartnership items if the taxpayer is contesting either issue.

2. A partner should continue to be allowed to petition the Tax Court and to elect to intervene in a partnership action until 210 days after the issuance of the Final Partnership Administrative Adjustment (the "FPAA"), as under the current Rules, instead of the proposed period of 90 days from the first valid petition.

3. Assuming the preceding recommendation is adopted, the Tax Matters Partner should be allowed to notify

[1] This report was prepared by The Committee on Partnerships, Steven C. Todrys and R. Donald Turlington, Co-Chairs. The report was drafted principally by Stephen L. Hillman and Robert S. Ocko. Helpful comments were received from Herbert L. Camp, Arthur R. Rosen and George E. Zeitlin.

other partners of a petition within 15 days, as under the existing Rules, instead of the proposed 5 days.

4. A Tax Matters Partner who wishes to consent to an entry of judgment should be required to certify that the consent of all partners has been obtained.

5. When the Tax Matters Partner is not willing to certify to having obtained consent of all partners to entry of judgment, the Commissioner, rather than the Tax Matters Partner, should send notice of the proposed settlement to all partners.

6. If a partner who has not previously elected to participate in an action objects to a proposed settlement, and the proposed settlement could have a more adverse impact on the objecting partner than the FFAA, the objecting partner should be permitted to intervene as of right at that time.

Introduction

The unified partnership audit procedures were adopted in 1982 as part of the Tax Equity and Fiscal Responsibility Act. These procedures apply to most partnerships for years beginning after September 3, 1982.[2]

[2] Certain partnerships with 10 or fewer individuals as the only partners are not subject to the unified audit rules, but can elect to be included. The audit rules also apply to some partnerships for the partnership year containing September 1982 which elect to have the audit rules apply.

Under the unified audit rules, the partnership items for a partnership for a given year can only be audited at the partnership level.

The Service must provide notice to all “notice partners”--all partners if the partnership has 100 or fewer partners, partners with a 5% or greater profits interest otherwise--of the commencement of the audit. A single partner, the “Tax Matters Partner” (“TMP”) will deal directly with the Service during the audit. The TMP is required to keep all other partners informed of the progress of the audit; for partners who are not notice partners this includes sending a copy of the notice of commencement of the audit.

At the conclusion of an audit, the Service may issue the FPAA describing all the changes it proposes to make to partnership items. The FPAA is sent by the Service to the TMP and all notice partners and by the TMP to all other partners. The issuance of the FPAA, which is equivalent to a notice of deficiency, allows the partnership to contest the adjustments in court.

The basic premise of the unified audit rules is that there will be only one court proceeding. The TMP has the first opportunity to initiate a proceeding (in District Court, Claims Court or Tax Court) for 90 days. If the TMP does not institute a proceeding, any notice partner or any other group of partners representing 5% or more of the interests in partnership profits

may commence a proceeding; if any such proceeding is brought in Tax Court, that proceeding continues. Otherwise, the first proceeding filed continues.

Regardless of how a partnership proceeding is commenced or in what court, all partners, even partners who are not notice partners, have a right to participate in the suit. The outcome of the suit fixes the treatment of partnership items. The Service can adjust the tax of each partner to reflect the final adjustments to partnership items.

The Tax Court promulgated initial rules for commencing partnership litigation in 1984. These rules specified the content and form of a Tax Court petition, the method of notifying partners and the time periods for electing to participate. In particular, the Rules required the TMP to be served copies of all petitions and to notify other partners of the filing of a suit within 15 days of learning of it. Within 210 days of the issuance of the FPAA, each partner could elect to participate in the continuing suit.

The proposed changes appear to be prompted by additional experience with partnership litigation. Some of the changes add helpful cross references and gender-neutral language. Others would change some of the details of filing a petition and some of

the time periods. In addition, new rules that define a “party” to a partnership proceeding and a participant to the action would provide guidance about the rights of the various partners in litigation. In general, these rules would permit each participating partner all the rights of a party in a non-partnership litigation.

Most of these changes are welcome. There are, however, a number of areas in which we believe the proposed Rules could be improved. Several of these relate to the role given the TMP and problems that arise when the TMP does not carry out his duties.

Role of Tax Matters Partner

The Rules use the TMP as the focal point of the procedural requirements--partners other than the TMP get much of their information, including notice that petitions have been filed, from the TMP. This is consistent with the intent of the unified audit rules and Reg. §301.6223(g)-1T and helps to centralize the litigation. In most instances, we believe this approach has worked well.

Recent experience indicates, however, that excessive reliance on the TMP can sometimes produce inappropriate results. Particularly in partnerships marketed some years ago as tax shelters, the original TMP was often the promoter and the only general partner. By the time of the audit, the partnership may have become largely dormant and the TMP/promoter may no longer be

an active participant. In some instances, the TMP is in bankruptcy or is on the verge of insolvency.[3] in such cases it may not be clear whether the original partner is still the TMP or who is the successor TMP. In other instances, the TMP is a single-purpose corporation that no longer exists or has ceased to conduct business in any real sense and cannot be expected to provide information to the other partners. In a few cases, the other partners are in civil litigation against the TMP; the TMP may well try to take advantage of any superior position he may have in the tax litigation to force a settlement on the other partners in the civil litigation.

Circumstances like these put tremendous pressure on the audit rules in general. We recognize that the rules for partnership litigation, like the pre-litigation audit procedures, must necessarily depend on the TMP fulfilling the role assigned to him if the unified audit procedures are to provide any significant improvement over partner-by-partner audit and litigation. Nonetheless, there are some areas of the proposed changes in the Rules that place an unnecessary degree of reliance on the activity of the TMP; those Rules are unlikely to work well if the TMP is bankrupt or dormant or if the TMP is in an adversarial position with other partners. We have pointed out

[3] The Tax Court has already had to deal with the consequence of a TMP insolvency in at least one case, Computer Programs Lambda, 89 T.C. No. 17 (1987).

below the specific areas where we think it might be appropriate for the Rules to provide more direct participation by some other partners, as well as several other specific areas not relating to the role of the TMP.

Issues Specific to Particular Rules

1. Rule 241(d)(3)(ii). Content of Petition

The changes proposed for Rules 13, 20, 25, 34 and 38 simply add appropriate cross references. The change to Rule 240, which describes the captions for partnership actions, is also not substantive. Rule 241, however, describes the content of a petition by a partner. In most respects, the requirements are to be expected: names, addresses, status of petitioner (as TMP or not), basis for jurisdiction and asserted errors.

The requirement that a petition by a partner other than the TMP state that the partner has an interest in the outcome within the meaning of §6226(d) is not new but merely renumbered and rephrased. However, we think that in some instances the requirement is overbroad. We are concerned that the statement required by the petition may constitute an admission by the petitioner of an issue that is in fact in dispute. The situation is analogous to the traditional problem of having to submit to jurisdiction of a court even to contest jurisdiction.

Suppose, for example, that the Service contends that the partnership return for calendar year 1988 was fraudulent. Assume the return was filed when due on April 15, 1989 and the FPAA is issued on April 30, 1996. Under §6226, the FPAA is timely only if the Service is correct that the return was fraudulent and only as to those partners who were knowing participants in the fraud. (As to any other partners the six-year period of §6229(c)(1)(B) has run.)

Suppose C is a partner who wishes to protest that the return was not fraudulent and that, in any event, she was not a knowing participant in the fraud. C is within §6226(d) if and only if the return was fraudulent and she was a knowing participant. Hence the requirement that C state facts to show that she meets the §6226(d) conditions requires C to admit precisely the facts she wishes to contest.[4] We think that C should be entitled to raise substantive issues in the partnership litigation without losing her right to argue that in fact the limitations period has run as to her.

[4] It might be argued that the issue of whether C was a knowing participant is not a partnership item and should be resolved in the subsequent "affected item" litigation. We do not take a position on this question. It is enough that C has a legitimate interest in being heard on the issue of whether the return itself is fraudulent--the kind of issue that surely should be resolved in the partnership litigation, C also has a legitimate interest in being heard on the determination of the correct amount of partnership items if the return was incorrect.

Other issues inherent in §6226(d) can arise between the petitioner and the Service. For example, the petitioner may claim that the notice of commencement of audit was not mailed to her on a timely basis and that under §6223(e)(3) she has the right to elect that as to her, all items are nonpartnership items. If the Service does not concede that she has the right to make the election, the partner should be entitled to participate in the partnership litigation since she may be affected by its outcome.

We propose that insofar as §6226(d) is concerned the petitioner merely be required to state that the Service has not conceded all issues that would remove the petitioner from §6226(d) and should separately be required to state the basic underlying facts as he knows to be true: (i) when the return was filed, (ii) when the limitations period appears to have run, and (iii) whether the partnership items have been declared nonpartnership items. In order to effectuate the intent of §6226(d), we propose that the Service be permitted to concede that a partner who claims to be excluded from the litigation is not a person with an "interest in the outcome".

2. Rule. 241(f). Period for TMP to supply Notice to Partners.

This amendment shortens from 15 days to 5 days the time period within which a TMP has to provide notice that a petition was filed. The Rules use the TMP to coordinate the flow of information about commencement of litigation to the partners. If

the TMP files a petition in Tax Court, he must notify every partner of the petition and, if so requested, supply a copy of the petition. If another partner files a petition in Tax Court, he is required to serve a copy on the TMP. The TMP is then required to notify all the partners of the petition and to provide a copy if so requested by a partner.

Under the present Rules the TMP has 15 days to provide the notice. The proposal would change this to 5 days. In normal course that period should be realistic for a general partner who was intended to be the TMP.

There are, however, circumstances in which the 5-day period may create difficulties. One is when the TMP is a limited partner acting as TMP because the original general partners are no longer available. The limited partner may not have the information and resources available to notify the other partners promptly.

Even so, if the proposal in Rule 245(a) for a 90-day period for a partner to elect to intervene is adopted, a TMP should be required to send notice of the filing of a petition within 5 days in order to give the recipients adequate time to decide what they want to do. However, as we note in the next section, we think present Rule 245(a) should be retained. If the Rule 245(a) time period is not changed, it is not clear that a reduction of the TMP's time to send notice of a petition from 15 days to 5 days is necessary.

3. Rule 245(a). Time within which to elect to participate.

The amendment changes the time within which a partner may move to intervene from 210 days after issuance of the FPAA to 90 days after the petition is filed in the continuing case. Section 6226(c) permits any partner to intervene in the partnership action, even a partner who would not be a notice partner. The current Rules give a partner until 210 days after the issuance of an FPAA to intervene in a Tax Court action. The proposal would instead give the other partners 90 days from the filing of the continuing Tax Court petition to elect to intervene. This change creates a significant risk to other partners should the TMP fail to provide the required notice of filing of a petition in a timely manner.

If the TMP acts properly, each partner will know whether and when a petition has been filed and can elect to intervene in a timely fashion. Suppose, however, that the TMP (or a partner claiming to be the TMP) does file a petition in Tax Court on the 10th day after the FPAA is issued but does not notify all partners. All notice partners are assured of having received a copy of the FPAA, even if the TMP is derelict, since the FPAA is sent by the Service. Thus, under the existing Rule, a notice partner who does not receive any notice of the petition can safely wait until the 150th day to file his own petition under

present Rule 245(a). Under the proposed Rule, however, the petition on day 149 would be invalid. If the petition does not include a protective request to be treated as an election to intervene if the petition is not the first, the partner may be precluded from participating for no good reason.[5] in effect, under the proposed Rules, a partner who does wish to participate but has not received any notice from the TMP of a prior petition can only protect his absolute right to participate by filing a petition and a protective election to participate on the 91st day since a petition could have been filed by the TMP on the first day.

4. Rule 247. Parties and participants.

Rule 247 distinguishes between parties to the litigation (all partners who will be bound by the outcome) and participating partners (all partners who elect to intervene or participate). The distinction as made seems to be appropriate. The general scheme is that outside of Rules 240-251 references to “parties”

[5] We recognize that the Court has refused to treat a petition filed later than the continuing petition as an automatic election to intervene in the action. (See Computer Programs Lambda, supra.) This seems to imply that a well-advised partner filing a petition should simply add to his petition a request to intervene if it should be determined that there was an earlier valid petition. The Court's refusal to treat each petition as an election to intervene seems on its face to reach the wrong result (excluding a partner who wishes to participate) more often than it reaches the right one (excluding a partner who only filed a petition because he thought no other petition had been filed).

will usually be treated as references to participating partners.

Although many of the Rules implicitly assume that there will be only two parties involved in the litigation, we read this Rule as implying that in general each participating partner will have the full rights of a party independent of any other participating partner. Thus, it would appear, for example, that under Rule 70, subject to the power of the Tax Court to limit discovery, each participating partner will have the right to make separate discovery requests.

The Rules do not generally anticipate true multiparty litigation with different petitioners adverse to each other. In light of the possibility that some of the participating partners will have adverse interests, we recommend that the rights of participating partners vis-a-vis each other be spelled out in more detail. For example, it would be useful to make explicit the right of each partner who is a participant to seek separate stipulations and the right of each participant to cross-examine the witnesses of the Service and of any other participant.

5. Rule 248(a). TMP consent to entry of decision.

Proposed Rule 248 deals with settlements of partnership actions and entry of judgment. The current Rules do not provide any guidance on this topic. The proposed Rule takes a tripartite approach. In the first instance, if the TMP is willing

to sign the entry of judgment, his signature is conclusively taken under proposed Rule 248(a) as proving that no partner objects. If the TMP is not willing to sign under these conditions but all participating partners have agreed to the settlement, proposed Rule 248(b) provides a procedure for the TMP to notify all the other partners of the proposed decision. The other partners then have 60 days to object and to move to participate in the action. The motion to participate is within the discretion of the Court, however, and if it is denied, the judgment will be entered. Finally, if all participating partners are not willing to settle, proposed Rule 248(c) provides for the Service to notify the Court and the TMP of any settlement with a partner and for the TMP to notify all the other partners.

Proposed Rule 248(a) would presume the signature of the TMP on the consent to entry of decision to have been made with the consent of all parties. As to partners who have not elected to participate, this may be a reasonable assumption. However, where other partners have elected to participate, it is reasonable to assume that the other participating partners do not fully trust the TMP. These other partners may be actively engaged in litigation against the TMP.

It would appear that, under the proposed Rule, even if the TMP in fact does not have the consent of all the parties, his signature will be conclusive, and the other partners will have as

their only remedy civil litigation for difficult-to-prove damages. Partners who have indicated their discomfort with the TMP conducting the litigation by electing to intervene should not be at risk that a TMP in whom they have indicated a lack of confidence will behave improperly and consent to entry of a decision without actually obtaining their consent first. If the participating partners do wish the TMP to have this authority in a particular case, they can provide it by powers of attorney limited to this purpose.

The appropriate Rule for nonparticipating partners is less clear. Under some circumstances it may be reasonable to rely upon the signature of the TMP as indicating that the consent of all nonparticipating partners has been obtained. On the whole, however, we think that the general structure of proposed Rule 248(b), which provides for notice to all parties and an opportunity to object, is more appropriate. Unless the partnership agreement contains a grant of such authority to the TMP, we doubt that a well-advised TMP would undertake to sign the entry of decision without making an inquiry of all partners. In practice, therefore, a TMP will usually have to send notices to all partners regardless of whether he intends to act under Rule 248(a) or chooses to use Rule 248(b), the only difference being that under Rule 248(a) a TMP who is minded to ignore his responsibilities has the power to bind the other partners. We

recommend that, at the least, the obligation of the TMP to obtain the consent of all partners be made explicit and that the TMP be reminded of this obligation by being required to certify that it has obtained the consent of all partners.

6. Rule 248(b). Objection to settlement by non-participating partners.

Rule 248(b) allows a nonparticipating partner an opportunity to object to a proposed settlement, assuming the TMP is adequately performing his function. The risk that the TMP is not performing his assigned function is especially relevant, however, to an action that can terminate the litigation. We therefore recommend that the Service, rather than the TMP, be required to send the notice to all partners. This should prevent any concern that not all partners were notified.

If a partner does object, the proposed Rule simply grants leave to apply to intervene which, according to the commentary, will not be granted unless an objecting partner makes a “strong showing”. If a partner who has not elected to intervene objects to a settlement which is more adverse to him than the FPAA, the objecting partner should be entitled to intervene as of right. In the absence of such a right, it would seem that every partner is best advised to elect to intervene during the of-right period simply to preserve its right to prevent a settlement on unpredictable terms possibly more adverse to it than the FPAA.

Since the objective of the Rules is to limit the litigation to a manageable number of active participants (ideally to one participant), the Rule should not drive partners to elect to intervene before they have visible reason to do so. A partner who may suffer more under the proposed settlement than under the FPAA should, therefore, be allowed to intervene as of right if he objects to the settlement.