What Happened to My Prepayment Forum?  
The Penalty Problem in TEFRA Partnership Audit Cases  
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Since 1924, when Congress established the Board of Tax Appeals, predecessor of the Tax Court, it has been a fundamental principle of our Federal income tax structure that a taxpayer “is entitled to an appeal and to a determination of his liability for the tax prior to its payment.” This principle has been consistently applied as well to additions to tax and penalties with respect to income taxes, beginning with the addition to tax for negligence imposed by the Revenue Act of 1924, and continuing right down to the present-day penalty for underpayment of tax required to be shown on a return by reason of negligence, “substantial understatement,” or other causes.

Statutory amendments made by the Taxpayer Relief Act of 1997, however, limit taxpayers’ access to such a “prepayment forum,” in the case of “partner-level” defenses to income tax penalties attributable to “partnership items,” and may permit the IRS to assess and to collect such penalties even before a taxpayer has the opportunity to obtain a judicial determination of the validity of the taxpayer’s “partner-level” defenses. The 1997 rules have added yet further confusion to the already complex procedural rules governing audits and litigation concerning “partnership items.” Some very recent decisions highlight this confusion, reveal a degree of judicial discomfort with the 1997 rules, and raise some uncertainty regarding just how broadly they will be applied.

BACKGROUND

Before looking at the recent cases, it will be helpful to review the statutory and regulatory context.

Accuracy-Related Penalties

Internal Revenue Code (“Code”) section 6662 imposes an “accuracy-related penalty” on certain underpayments of tax liability. The penalty applies to the portion of any underpayment which is attributable to one or more of: (1) negligence or intentional disregard of rules or regulations; (2) any substantial underpayment of income tax; (3) any substantial valuation misstatement under chapter 1 of the Code; (4) any substantial overstatement of pension liabilities; or (5) any substantial estate or gift tax valuation misstatement.
The penalty is normally equal to 20% of the portion of the underpayment to which section 6662 applies. For “gross valuation misstatements,” the penalty rate is increased to 40%.

Code section 6664(c), however, provides an important exception: “No penalty shall be imposed under section 6662 ... with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.”

Pre-Assessment Review of Tax and Penalties Under TEFRA

A taxpayer’s entitlement to obtain a judicial determination of liability for tax and penalties prior to payment is now contained in Section 6213(a), which provides, in part, that “no assessment of a deficiency in respect of any tax imposed by subtitle A or B, chapter 41, 42, 43, or 44 and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until [a notice of deficiency] has been mailed to the taxpayer, nor until the expiration of such 90-day ... period [for filing a petition with the Tax Court after a notice of deficiency has been mailed], ... nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final.”

In title IV of TEFRA, Congress provided that tax treatment of the “partnership items” of certain partnerships should be determined at the partnership level. In partnership proceedings subject to the TEFRA provisions, the Service, in lieu of sending a notice of deficiency, is required to send a “notice of final partnership administrative adjustment” (“FPAA”) to each partner. If a petition is filed in the Tax Court challenging the FPAA, no assessment of a deficiency attributable to any partnership item may be made before the decision of the Tax Court has become final.

If the IRS wishes to assert a deficiency against a partner attributable to items “affected by” partnership items (“affected items”), other than items that are purely computational, it must wait until the partnership proceeding is completed, either by the partners’ failure to file a petition in any court with respect to the FPAA or by the resolution of the partnership-level litigation. After the partnership proceeding has been completed, the Service must then issue a notice of deficiency to the partner, which then gives the partner the right to file a petition with the Tax Court and thereby bar assessment and collection of the asserted deficiency until the Tax Court decides the case.

Under the TEFRA provisions, as originally enacted, penalties attributable to partnership items were considered “affected items.” Thus, the penalties could be asserted against a partner only following completion of partnership-level proceedings, and then only by means of application of partner-level deficiency procedures – including the partner’s ability to challenge the partner-level notice of deficiency on a pre-payment basis by filing a petition with the Tax Court.

Even if a petition challenging the FPAA were filed in a court other than the Tax Court, with the effect that any deficiency in tax attributable to the adjustments made in the FPAA could be assessed without further judicial review, penalties attributable to partnership items still
required application of the deficiency procedures after completion of partnership-level proceedings.\textsuperscript{13}

**TRA ’97: Limitations of Prepayment Review of Penalties**

Congress became dissatisfied with this regime and made significant statutory changes in TRA ’97.\textsuperscript{14} The legislative history of TRA ’97 explains the reasons for change and provides an overview of the new provisions:

“Many penalties are based upon the conduct of the taxpayer. With respect to partnerships, the relevant conduct often occurs at the partnership level. In addition, applying penalties at the partner level through the deficiency procedures following the conclusion of the unified proceeding at the partnership level increase the administrative burden on the IRS and can significantly increase the Tax Court’s inventory. …

“The bill provides that the partnership level proceeding is to include a determination of the applicability of penalties at the partnership level. However, the provision allows partners to raise any partner-level defenses in a refund forum.”\textsuperscript{15}

In order to implement this new system, TRA ’97 amended three provisions of the Code, as shown in italics below.

(1) Section 6221 was amended as follows: “Except as otherwise provided in this subchapter, the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level.”

(2) Section 6226(f) was amended to read: “A court with which a petition [for judicial review of an FPAA] is filed in accordance with this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership administrative adjustment relates, the proper allocation of such items among the partners, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.”

(3) Finally, Section 6230(c)(4), which relates to partner-level refund suits following completion of the partnership-level proceeding, was amended to read: “For purposes of any claim or suit under this subsection, the treatment of partnership items on the partnership return, under the settlement, under the final partnership administrative adjustment, or under the decision of the court (whichever is appropriate) shall be conclusive. In addition, the determination under the final partnership administrative adjustment or under the decision of the court (whichever is appropriate) concerning the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a
partnership item shall also be conclusive. Notwithstanding the preceding sentence, the partner shall be allowed to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment.”

Treasury Regulations to implement this new structure were promulgated on a temporary basis in early 1999, and the Regulations were finalized in late 2001. Reg. 301.6221-1 now provides:

“(c) Penalties determined at partnership level. Any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item shall be determined at the partnership level. Partner-level defenses to such items can only be asserted through refund actions following assessment and payment. Assessment of any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item shall be made based on partnership-level determinations. Partnership-level determinations include all the legal and factual determinations that underlie the determination of any penalty, addition to tax, or additional amount, other than partner-level defenses specified in paragraph (d) of this section.

“(d) Partner-level defenses. Partner-level defenses to any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item may not be asserted in the partnership-level proceeding, but may be asserted through separate refund actions following assessment and payment. See section 6230(c)(4). Partner-level defenses are limited to those that are personal to the partner or are dependent upon the partner’s separate return and cannot be determined at the partnership level. Examples of these determinations are whether any applicable threshold underpayment of tax has been met with respect to the partner or whether the partner has met the criteria of section 6664(b) (penalties applicable only where return is filed), or section 6664(c)(1) (reasonable cause exception) subject to partnership-level determinations as to the applicability of section 6664(c)(2) [relating to special rules for certain valuation overstatements].”

In promulgating these Regulations, Treasury intended that the majority of the defenses to the application of a penalty be determined at the partnership level. Thus, in Santa Monica Pictures, LLC, TC Memo 2005-104, RIA TC Memo ¶2005-104, the Tax Court evaluated actions taken, and professional advice received, by a partner in the course of preparation by that partner of a partnership’s tax returns. The court found the partner’s actions on behalf of the partnership to have been inadequate and held that the partnership had thus not demonstrated that there was reasonable cause for any underpayment caused by its erroneous reporting. Accordingly, the partnership failed to establish a partnership-level “reasonable cause and good faith” defense under Section 6664(c) to the assertion of accuracy-related penalties against the partners in the partnership. The fact that the individual whose actions were being evaluated happened to be a partner did not cause the determination to be a partner-level determination, where the individual’s actions were taken on behalf of the partnership and related to preparation of the partnership return.
Nevertheless, the Regulations recognize that whether certain defenses apply to a particular partner, particularly the “reasonable cause and good faith” defense, can in many cases be determined only by reference to the actions and state of mind of the partner against whom the penalty is asserted. The section 6664(c) defense would be available as a “partner-level” defense to a partner who could demonstrate that, however improperly the partnership may have acted in preparing its return, the partner acted properly – in the partner’s individual capacity, rather than in the partner’s capacity as an agent or representative of the partnership – in incorporating the partner’s distributive share of the partnership’s reported income or loss onto the partner’s individual return.

Example: An individual limited partner in a partnership receives a Schedule K-1, indicating that certain losses were allocated to the partner. The individual, feeling perhaps justifiably uncomfortable with the level of care that was employed in preparation of the partnership’s return, asks a competent tax professional to investigate the matter thoroughly before the individual claims the losses on the individual’s personal return. The professional appropriately researches the factual and legal issues and advises the taxpayer in writing that the loss deductions are proper. On audit, the Internal Revenue Service disallows the losses and asserts a penalty under Section 6662 against all partners in the partnership. If the court that is adjudicating the partnership proceeding determines that the partnership did not employ due care in the preparation of its return, a penalty may be assessed against and collected from even this individual with respect to any underpayment attributable to the claiming of the losses. The court adjudicating the partnership proceeding will not permit the individual to raise the defenses arising from the additional partner-level actions that were taken to attempt to ensure compliance with the law. The individual’s only remedy will be to pay the asserted penalty and to commence a refund suit.

In summary, the “plain meaning” of the statutory and regulatory regime following TRA ’97 is to permit partnership-level, but not partner-level, defenses to application of a penalty to be asserted in a partnership administrative and judicial proceeding, and, if a partnership files a petition with the Tax Court, the Court of Federal Claims, or a U.S. district court with respect to an FPAA, to prohibit penalties from being assessed or collected until the partnership-level litigation is concluded. Once partnership-level litigation is concluded, however, penalties may be assessed and collected immediately, with no opportunity to raise partner-level defenses prior to payment. Not surprisingly, several recent cases have reflected challenges by partners to this understanding of the rules.

Recent Cases: Do the Words Mean What They Say?

_Klamath Strategic Investment Fund, LLC, 99 AFTR 2d 2007-850, 472 F. Supp. 2d 885 (DC Tex., 2007),_ involved a marketed transaction – described by the court as a “tax shelter” – known as “Bond Linked Issue Premium Structure,” or “BLIPS,” which was effected by the partnership, Klamath. One important aspect of the tax structure of the transaction involved a purported borrowing by one of the partners in Klamath, Cary Patterson, liability for which was subsequently assumed by Klamath.
The tax benefits claimed by Patterson had arisen from his sale, during 2000, 2001, and 2002 – when he was no longer a partner in Klamath – of property distributed to him during 2000 by Klamath in liquidation of his interest in Klamath. Patterson had claimed that the property had an extremely high basis in his hands, with the effect that he had recognized large losses on its sale. Both before and after his withdrawal from Klamath, Patterson had consulted with tax counsel (described by the court as “qualified tax attorneys”) regarding the allowability and proper reporting of the losses to be claimed on the sale of the property distributed to him by Klamath. Tax counsel provided a “detailed” and “comprehensive” written opinion to Patterson, apparently concluding that the losses would be allowable.24

The losses were challenged by an FPAA issued by the Service to Klamath with respect to 2000, the year of the distribution.25 The court evaluated the “economic substance” of the transaction, held that the borrowing by Patterson lacked economic substance, and concluded that Patterson’s basis in the property distributed to him by Klamath was much lower than he had claimed and that his losses should accordingly be disallowed.

The court then turned to the applicability of the accuracy-related penalty of Section 6662 that had been asserted by the Service on the grounds, *inter alia*, of substantial understatement of income tax.26 Under the Code as in effect during the years in issue in *Klamath*, a penalty for substantial understatement of income tax would not be imposed with respect to an item if “there is or was substantial authority” for the taxpayer’s treatment of that item; in the case of certain “tax shelter items,” this “substantial authority” exception was unavailable unless, in addition to there being substantial authority, the “taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.”

The court concluded that the written opinion received by Patterson “provide[d] ‘substantial authority’ “ for Patterson’s computation of basis,27 and that Patterson reasonably believed that his treatment of the borrowing transaction was more likely than not the proper treatment. To your author, the court’s analysis of the “substantial authority” issue – which turned on evaluation of a written opinion that had been solicited and received by Patterson at a time when he was no longer a partner in Klamath and that thus indisputably could not have been taken into account by Klamath in preparing its return or determining its own tax filing positions – clearly implicated “partner-level defenses,” and one would have expected the Government to object to the court’s analysis on that ground.28 Nevertheless, no such objection to this portion of the court’s analysis was apparently made by the government.

The court having concluded that the “substantial authority (and reasonable belief that more likely than not)” exception to application of the Section 6662 accuracy-related penalty applied, there does not seem to have been a reason for the court to go on and consider whether the Section 6664(c) “reasonable cause and good faith” exception to application of that penalty also applied – but the court did so anyway. In the course of its discussion, the court raised some important questions about the effect of the amendments made by TRA ’97.

Patterson asserted that the Section 6662 penalty should not apply to him, on the grounds that he, individually, met the requirements for the “reasonable cause and good faith” exception. Patterson further asserted that, although the 1997 amendment to Section 6230(c)(4) permitted the
bringing of a refund suit to assert partner-level defenses to a penalty, he could also raise such defenses in the partnership proceeding, particularly when the substantive adjustment giving rise to the underpayment for which he was to be penalized arose from a determination that a loan transaction – to which he, rather than the partnership, was the original party – lacked economic substance. The government contended that the “reasonable cause and good faith” exception was a partner-level defense and that, under the 1997 amendments, partner-level defenses were not permitted to be raised in a partnership proceeding.

The court concluded that it could consider Patterson’s “reasonable cause and good faith” defense. The court’s opinion, however, suggests that the court did not accept Patterson’s assertion that a refund suit was not the exclusive remedy available for the assertion of partner-level defenses, as such. Rather, the court’s preferred articulation appears to be that, in some cases, the question of whether or not an individual partner satisfies the “reasonable cause and good faith” exception is itself a partnership-level defense.

The district court noted that in Santa Monica Pictures the Tax Court had looked to the actions of a particular partner in determining whether or not the partnership satisfied the “reasonable cause and good faith” requirements, and analogized that to the situation it faced in Klamath, in which it was required, in order to evaluate the substantive tax issues before it, to look at the economic substance of a transaction (the borrowing) in which Patterson individually had participated. Thus, in this particular case, Patterson’s individual “reasonable cause and good faith” was not an item that, in the words of Reg. 301.6221-1(d) (quoted above), is “personal to the partner or dependent on the partner’s separate return” or an item that “cannot be determined at the partnership level.”

Jade Trading, LLC, 100 AFTR 2d 2007-7123, 80 Fed. Cl. 11 (Fed. Cl. Ct., 2007), stands in sharp contrast to Klamath, although the background of the two cases is very similar. Like Klamath, Jade involved a marketed transaction, at the end of which individuals sold, at what was purportedly a large loss, property that had been distributed to them in liquidation of their interests in a partnership. Like the court in Klamath, the Court of Federal Claims in Jade concluded that the transaction lacked “economic substance” and disallowed the claimed loss.

As it did in Klamath, the IRS in its FPAA in Jade asserted accuracy-related penalties against the individual taxpayers. As the individual taxpayer did in Klamath, the individual taxpayers in Jade tried to get the court reviewing the FPAA to consider their own “reasonable cause and good faith” as grounds not to uphold the assertion of the penalty. And there the court in Jade turns away from Klamath.

The taxpayers in Jade made two arguments in favor of being able to raise their own “reasonable cause and good faith” in Jade’s partnership proceeding. First, they challenged the validity of Reg. 301.6221-1(d) (set out above), which explicitly articulates the rule that partner-level defenses may not be raised in a partnership proceeding is invalid, partly on the grounds that it would deprive the individual partners of the “reasonable cause and good faith” defense explicitly granted to them by Section 6664. The Court of Federal Claims rejected this argument, noting that, while the Regulation made it more burdensome for the individuals to assert their defense, they could still do so by means of a refund suit.

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Second, the individual taxpayers in *Jade* cited *Klamath* for the proposition that, even under the Regulation, “partners may raise a partner-level reasonable cause defense at a partnership-level proceeding.” The court in *Jade* distinguished *Klamath* on the basis that the individual taxpayers in *Jade*, unlike Patterson in *Klamath*, had had no role in the management of the partnership or in the preparation of its tax filings. Accordingly, the individual partners were not permitted to raise issues relating to their individual “reasonable cause and good faith” in the partnership proceeding. If the decision of the Court of Federal Claims in *Jade* is upheld (or if there is no appeal from that decision), the individual partners will have to pay the asserted penalties and sue for a refund, if they wish to raise their “partner-level” defense.

**Stobie Creek**

Most recently, the Court of Federal Claims was presented with an opportunity to revisit this issue in *Stobie Creek Investments, LLC*, 101 aftr 2D 2008-1151 (Fed. Cl. Ct., 2008), but declined to change its views.

Partners in Stobie, the partnership before the court, sought an order confirming that, at the trial of the partnership proceeding, their individual “reasonable cause and good faith” defenses would be adjudicated. The government opposed the partners’ motion, but conceded that any issues relating to partnership-level “reasonable cause and good faith” were properly before the court.

The partners’ primary argument was based on the words of the legislative history of the TRA ’97, quoted above: “The bill provides that the partnership level proceeding is to include a determination of the applicability of penalties at the partnership level. However, the provision allows partners to raise any partner-level defenses in a refund forum.” Based on this language, the partners argued that a refund suit was merely one allowable alternative for raising partner-level defenses, and that they should be permitted to take advantage of what they viewed as another allowable alternative, *i.e.*, raising them in the partnership proceeding itself. The Court of Federal Claims rejected this reading and concluded that the applicable statutory and regulatory provisions made a refund suit the exclusive means of raising a partner-level defense.

There are a few additional points of note in *Stobie*. First, the court did indicate that it would consider actions taken by the managing partner, presumably in his capacity as such, in determining the applicability of penalties. This seems entirely consistent with existing authority, such as *Santa Monica Pictures*.

Second, the court rejected other arguments made by the individual partners to permit the consideration of partner-level defenses, one of which was based on a “creative” reading of the Rules of the Court of Federal Claims and the other of which was grounded in an attempt to amend their complaint to join a partner-level claim for refund of penalties, brought under the general jurisdictional statute of the Court, with the partnership-level proceeding commenced by the FPAA.
Like the individual partners in *Jade*, it appears likely that the partners in *Stobie* will have to pay any asserted penalties before they can commence refund actions in which they can raise partner-level defenses, such as individual “reasonable cause and good faith.”

**CONCLUSION**

In the two most recent partnership proceedings to consider the issue, taxpayers have been unsuccessful in persuading the Court of Federal Claims to consider partner-level defenses to an asserted accuracy-related penalty. Accordingly, if an opportunity to raise such defenses prior to paying a penalty is of significant concern, one should certainly consider selecting a forum in which the issue is at least arguably still open – that is, a forum other than the Court of Federal Claims – in which to litigate a partnership proceeding in which penalties have been asserted.

In fact, the validity of Regs. 301.6221-1(c) and (d) is at issue in several partnership proceedings now pending in the Tax Court, as mentioned in *7050, Ltd.*, TCM 2008-112. In that very recent decision, a partnership proceeding, the Tax Court denied (without prejudice to renew) the Service’s motion for summary judgment that penalties should be imposed on the partners because the issue of the validity of the Regulations, which would bar the partners from raising partner-level defenses in the partnership proceeding, had not been briefed by the parties and was the subject of pending cases.

Nevertheless, the facts in even the most “favorable” case, *Klamath*, were such that the ability to raise, even in the most friendly forum, partner-level defenses in the partnership proceeding may have to be viewed as an exception, rather than a general rule. The words of the Code, Treasury Regulations, and legislative history may be so clear that no court will ordinarily allow the raising of such defenses in a partnership proceeding, but the advocate’s job will be to convince the court, as frequently as possible, that special factors are present to justify permitting a taxpayer to raise partner-level defenses in a partnership proceeding, prior to payment of the asserted penalties.\(^5\)

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3. Revenue Act of 1924, *supra* note 1, section 275(a) (imposing addition to tax for negligence and providing that it be “assessed, collected, and paid in the same manner as if it were a deficiency”).
4. Sections 6662 (imposing penalty) and 6665(a) (penalties to be “assessed, collected, and paid in the same manner as taxes”).
5. Each of these terms is defined in detail in section 6662.
6. In the case of “understatements” attributable to “reportable transactions,” a separate accuracy-related penalty is imposed by Section 6662A in lieu of the section 6662 penalty, and a separate “reasonable cause and good faith” exception is set out in Section 6664(d).
7. This prohibition was implicit in section 274(b) of the 1924 Act, which provided: “If the Board determines that there is a deficiency, the amount so determined shall be assessed and shall be paid upon notice and demand.” An explicit prohibition on assessment and collection prior to the taxpayer’s opportunity to obtain an adjudication from the Board, with language very similar to that found in the current Code, was added by section 274(a) of the Revenue Act of 1926, ch. 27, 44 Stat. 9.
Section 6221, effective for partnership taxable years beginning after 9/3/82. “Partnership items” are enumerated in Reg. 301.6231(a)(3)-1 and include the partnership aggregate and each partner’s share of items of income, gain, loss, deduction, and credit of the partnership, as well as a variety of other items “more appropriately determined at the partnership level.” “Small partnerships” described in Section 6231(a)(1)(B) are not subject to these rules added by TEFRA, and “electing large partnerships” are subject to a different regime pursuant to Sections 6240-6255.

Section 6223. If the partnership has more than 100 partners, partners with a less than 1% interest are not entitled to notice. Section 6223(b)(1).

Section 6225(a). Generally, any partner may file a petition with the Tax Court; see Section 6226(a), (b). If, however, if the “tax matters partner” of the partnership files a timely petition with a U.S. district court or the Court of Federal Claims, the other partners will be compelled to litigate in that forum, and any asserted deficiencies attributable to partnership items may be assessed and collected immediately.

See Section 6230(a)(2).

Treasury Regulation section 301.6231(a)(5)-1(e).

Temp. Reg. 301.6231(a)(6)-1T(c) (as added by T.D. 8128, supra note 12, prior to amendment by T.D. 8808, 1999-1 C.B. 682, 686) (assessment of penalty “shall be subject to the provisions of subchapter B of chapter 63 of the Code (relating to deficiency procedures)”, there was no suggestion that a penalty could be assessed earlier if a petition was filed with court other than the Tax Court); T.D. 8808 (Supplementary Information: Explanation of Provisions: Penalties Determined At the Partnership Level); H.R. Rep’t. No. 105-220, 105th Cong., 1st Sess. 685 (1997) 1997-4 (Vol. 2) CB 2155 (TRA '97 Conference Report). For a discussion of non-penalty computational adjustments made in the partnership-level proceeding, see Domulewicz, 129 TC 11 (2007).

P.L. 105-34, 8/5/97, section 1238. These changes became effective for partnership tax years ending after 8/5/97, so there still may be some pending audit or litigation activity that continues to be governed by the pre-1997 rules.


TD 8808, supra note 13.

TD 8965, 2001-2 CB 344.

In this regard, the Preamble to TD 8808, supra note 13, states: “In order to minimize the burden on individual partners to defend themselves by bringing their own refund suits, the temporary regulations incorporate a large number of defenses at the partnership level. The majority of a partner’s defenses to the imposition of penalties are not specific to a particular partner, but can be determined by reference to the activities of the partnership. The applicability of these defenses may be resolved at the partnership level during the partnership proceeding.” Similar concerns would exist with respect to the defense provided by Section 6664(d) to assertion of the penalty imposed by Section 6662A for understatements with respect to reportable transactions.

Section 6226(e) requires a partner filing a petition with the Court of Federal Claims or a district court to deposit the amount by which the partner’s tax liability would be increased if the FPAA were upheld, and Section 6225(a) permits immediate assessment and collection of tax from the other partners in that case. Thus, a prepayment forum is available to challenge the tax in a partnership proceeding only if a petition is filed with the Tax Court, and then only until the decision of the Tax Court becomes final; a taxpayer’s appeal of an adverse Tax Court decision will not prevent assessment of the tax, in the absence of the posting of a bond. See Sections 6225(a), 7485(b).

In contrast, Treasury apparently interprets the provisions requiring pre-litigation payment in the case of petitions filed with the Court of Federal Claims or a district court as being inapplicable to any penalties asserted in the FPAA, which are thus required to be paid only upon conclusion of the partnership proceeding. See the Preamble to TD 8965, supra note 17 (“it appears that Congress did not intend to require a deposit of penalties ... as a condition to bringing such an action,” so the Section 6226(e) Regulations were not amended to reflect TRA ’97); Reg. 301.6231(a)(6)-1T(a)(3) (“any penalty ... may be directly assessed as part of the computational adjustment that is made following the partnership proceeding”; there is no suggestion that a penalty could be assessed earlier if petition was filed with a court other than the Tax Court). But see Section 7485(b) (the amount of bond needed to stay assessment and collection of tax following adverse decision of Tax Court includes not only tax, but also interest and penalties).

Reg. 301.6231(a)(6)-1T(a)(3). An e-mail from the IRS Office of Chief Counsel dated 7/18/07, recently released to the public (see 2008 TNT 72-88), confirms that this is the Service’s reading (partner-level defenses, including
good faith and reasonable cause of individual investors, “may only be raised through subsequent partner-level refund suits”). In Fears, 129 TC 8 (2007), a partnership claimed a loss on its return for 2000. An individual partner in the partnership reported his distributive share of the loss on his individual return for 2000, thereby creating a NOL for that year, and then carried the loss forward to 2001. Use of the loss on the individual’s return for 2001 reduced his tax liability for that year. The IRS sent an FPAA to the partnership with respect to its 2000 return, disallowing the loss and asserting that the partners were liable for the Section 6662 penalty. No valid petition was filed with any court with respect to the FPAA, so the question of whether partner-level defenses could be raised in partnership-level litigation was not raised. The Tax Court held the Service was not required to send a notice of deficiency to the individual for 2001, the year in which he claimed that the partnership’s loss actually reduced his tax liability, prior to assessing and collecting a section 6662 penalty for that year. See also Domułewicz, supra note 13.

22 For a description and analysis of the “BLIPS” transaction, see Hickan, Of Lenity, Chevron, and KPMG, 26 Va. Tax Rev. 905, 925-29 (2007). The district court’s opinion also addressed the consequences of a substantively identical transaction effected by another taxpayer.

23 In making this borrowing, Patterson acted through St. Croix Ventures, LLC, a single-member LLC disregarded as an entity separate from Patterson for federal tax purposes.

24 The court’s opinion never quite says explicitly what the conclusions of the opinion of counsel were or at what level of certainty they were reached.


26 The FPAA also asserted “gross valuation misstatement,” “substantial valuation misstatement,” and “negligence or disregard of rules or Regulations” as alternative grounds for imposition of the penalty. The court’s discussion of those issues is beyond the scope of this article, except to note that the court concluded that none of those grounds for imposition of the penalty could be sustained.

27 As the court itself notes, Reg. 1.6662-4(d)(3)(iii) explicitly provides, “[c]onclusions reached in ... legal opinions or opinions rendered by tax professionals are not authority. The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an item.” By evaluating “substantial authority” by reference to the level of detail or comprehensiveness in the opinion received by Patterson, rather than by weighing the underlying authorities in favor of the treatment reported by Patterson against the weight of contrary authority, as required by Reg. 1.6662-4(d)(3), the court seemed to miss the objective nature of the substantial authority analysis; see Reg. 1.6662-4(d)(2). This is another reason, apart from the “partner-level” nature of reliance on the opinion received by Patterson, as discussed in text below, that the court should perhaps not have considered the opinion in this partnership-level proceeding.

28 If the court had determined, based solely on its evaluation of partnership-level defenses, that the accuracy-related penalty did apply, Patterson would not have been precluded from asserting in a refund suit that he had partner-level substantial authority, but would have been required to pay the penalty at the conclusion of the partnership proceeding and then to raise his claim of partner-level substantial authority in a suit for refund of the penalty. Compare Jade Trading, LLC, 100 AFTR 2d 2007-7123, 80 Fed Cl. 11 (Fed. Cl. Ct., 2007) (declining to consider opinion received by individual partner in determining whether the partnership was subject to accuracy-related penalty for negligence and, as discussed below, also declining to consider issues of partner-level “reasonable cause and good faith”).

29 After determining that it was proper for it to consider Patterson’s individual “reasonable cause and good faith” defense, the court concluded that he did, in fact, satisfy the requirements for that defense.

30 The analogy to Santa Monica Pictures, LLC, TC Memo 2005-104, RIA TC Memo ¶2005-104, appears inexact. In that case, the actions taken by the partner that were considered in the partnership proceeding were taken on behalf of the partnership. By contrast, in Klamath Strategic Investment Fund, LLC, 99 AFTR 2d 2007-850, 472 F. Supp. 2d 885 (DC Tex., 2007), at least some of the items on which Patterson relied in establishing his “reasonable cause and good faith” (such as the written legal opinion) were created after he was no longer a partner in Klamath, were provided to him as an individual (and not as a partner in Klamath), and had no bearing on the determination of the economic substance of the underlying transactions. (The Court of Federal Claims in Jade Trading, supra note 28, in the course of distinguishing Klamath from the case before it, describes Patterson as the “managing member” of Klamath but the opinions in Klamath do not appear to support that characterization; the
government’s Brief to the Fifth Circuit on appeal from the district court decisions in Klamath distinguishes Santa Monica Pictures on the grounds that Patterson was not the managing member of Klamath.)

The Klamath court apparently was also impressed by the fact that the IRS had “delved into these taxpayers’ defenses to penalties during the administrative process preceding these adjustments.... As a result, no administrative benefit would be gained by requiring additional proceedings.” For more on this case, see generally Lipton, “Klamath Dispatches Another Tax Shelter, But Without Penalties,” 106 JTAX 200 (April 2007).


32 As observed in note 30, supra, the opinions in Klamath do not appear to support Jade’s description of Patterson’s role in the management of Klamath; rather, the court in Klamath found Patterson’s involvement as a principal in one of the key transactions to be sufficiently analogous to the status of the managing partner in Santa Monica Pictures to justify treating Patterson’s investigation of the tax consequences as a partnership-level defense.

33 Following issuance of the opinion of the Court of Federal Claims, the taxpayers sought (1) reconsideration of the imposition of the negligence penalty and (2) a “clarification” of the court’s opinion – that would have had the effect of finding that the individual partners in fact had demonstrated “partner-level reasonable cause and good faith” – on which they would be able to rely in a subsequent refund action. On 3/20/08, the court issued a memorandum opinion in which it denied both the motion for reconsideration and the request for clarification; see 101 AFTR 2d 2008-1411 (Fed. Cl. Ct, 2008).

34 The judge in Stobie Creek Investments, LLC, 101 AFTR 2d 2008-1151 (Fed. Cl. Ct., 2008), declined to follow the opinion in Jade Trading, supra note 28, “because a motion for reconsideration on point is pending.” (On 3/20/08, that motion was denied; see note 33, supra.) Nevertheless, the reasoning and result in Stobie are, in fact, entirely consistent with Jade.

The judge in Stobie also stated that the opinion in Cemco Investors, LLC, 101 AFTR 2d 2008-768, 515 F3d 749 (CA-7, 2008), constituted a “withering rejection” of Klamath, and, for that reason, “decline[d] to put [the court’s] head in the Klamath noose now established by the Seventh Circuit in Cemco.” This statement is very difficult to comprehend. The district court in Klamath issued three opinions: (1) an opinion granting Klamath’s motion for summary judgment to the effect that Reg. 1.752-6, which had been promulgated after Klamath had implemented its transactions, was invalid insofar as it purported to apply retroactively to those transactions (see 98 AFTR 2d 2006-5495, 400 F. Supp. 2d 608 (CD Tex., 2006)); (2) an opinion (discussed at length in text above) holding that the asserted tax benefits were nevertheless unavailable, on the grounds of lack of economic substance, but rejecting the application of penalties (see 99 AFTR 2d 2007-850 472 F. Supp. 2d 885 (DC Tex., 2007)); and (3) an opinion denying the Government’s motion for reconsideration of the first opinion (see 99 AFTR 2d 2007-2001 (DC Tex., 2007)). The Seventh Circuit in Cemco does indeed disagree strongly with an opinion in Klamath, but that disagreement is with the first Klamath opinion that does not mention or discuss any penalty-related issues; Cemco, in turn, does not mention or discuss Klamath’s analysis of the penalty issues. It is hoped that the judge in Stobie will clarify the opinion, so that this incorrect reference does not become an ongoing source of confusion in this area. (For more on Cemco, see Walton and Austin, supra note 31.)

35 See note 15, supra (emphasis added).

36 In some limited cases, prepayment (but post-assessment) judicial review of partner-level defenses to asserted penalties may be available by means of a “collection due process” hearing under Section 6330. See, e.g., Callahan, 130 TC No. 3, Tax Ct. Rep. Dec. (RIA) 130.3, 2008 WL 31270; Lewis, 128 TC 48 (2007). The intricacies of the “collection due process” rules and the tactical considerations involved in attempting to take advantage of them are beyond the scope of this article.