PARTNERSHIP TAXATION: A PENALTY FOR FAILURE TO TREAT ITEMS IN A MANNER CONSISTENT WITH THE PARTNERSHIP RETURN IS SUBJECT TO DEFICIENCY PROCEDURES

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Partnerships are subject to special audit procedures. The current operative regime is TEFRA, which has been repealed but still governs partnerships for tax years commencing prior to December 31, 2017. Under TEFRA, partners are subject to an obligation to report any partnership items on their individual returns "in a manner which is consistent with the treatment of such partnership item on the partnership return." I.R.C. § 6222(a). Alternatively, a partner who does not wish to treat a partnership item in a consistent manner must file a notice alerting the IRS to the inconsistent treatment. I.R.C. § 6222(b). The failure to file the notice of inconsistent treatment can trigger penalties. I.R.C. § 6222(d).

On May 1st, the Tax Court addressed an interesting jurisdictional issue: If a partner is assessed an accuracy-related penalty under section 6662 of the Internal Revenue Code because he violates the consistent treatment requirement, is that penalty subject to deficiency procedures, which provide for Tax Court jurisdiction? In the court's view, it is, at least where no partnership item has been adjusted. *Malone v. Comm'r*, No. 22750-09, 2017 U.S. Tax Ct. LEXIS 17 (May 1, 2017).[1]

Bernard Malone, the taxpayer, was a partner in MBJ Mortgage Services America, Ltd. ("MBJ" or the "Partnership"), a partnership that was subject to TEFRA. 2017 U.S. Tax Ct. LEXIS 17 at *2. On its 2005 return, the Partnership reported installment sales and indicated that the taxpayer had received $3,200,748 in ordinary income and $3,547,326 in long-term capital gains. *Id.* In contrast, the taxpayer and his wife did not report the installment sales on their return; instead, they reported a long-term capital gain of $4,526,897 from the sale of his interest in MBJ. The couple also did not notify the IRS that they had treated partnership items from MBJ in an inconsistent manner. *Id.* at *2-*3. The IRS audited the couple's return; it issued a notice of deficiency in which it adjusted their return to reflect the omitted partnership items, disallowed the claimed capital gain because the partnership interest was not sold in the relevant tax year, and disallowed other deductions unrelated to the partnership. *Id.* at *3.

The Malones filed a petition with the Tax Court; in its amended answer, the IRS asserted that they were also liable for an accuracy-related penalty because of their failure to report a partnership item in a manner consistent with the partnership returns. *Id.* The IRS successfully moved to dismiss the petition to the extent that it raised partnership items; in disposing of that motion, the court reserved judgment on the issues surrounding its jurisdiction over the accuracy-related penalty. *Id.* at *3-*4. After the IRS clarified that it was asserting the penalty on the basis of the taxpayer's failure to report the partnership items, the court requested supplemental briefing on its jurisdiction over the penalty.

After reviewing the consistent reporting requirement and the general availability of accuracy-related penalties for violations, the Tax Court turned to the structure of TEFRA to determine whether it had jurisdiction to consider the penalty claim. As the court noted, under TEFRA, all partnership items are adjusted in a partnership-level proceeding. Once the partnership level proceeding is concluded, the next step in the process is to make adjustments to individual partners' returns. These changes can include adjustments to "affected items." *Id.* at *7. If an affected item can be adjusted without considering an individual partner's circumstances, then the IRS can assess additional tax, penalty, and interest without issuing a notice of deficiency. *Id.* (citing I.R.C. § 6230(a)(1); Treas. Reg. § 301.6231(a)(6)-1(a)(2)). If a factual determination is necessary at the individual partner level, however, the IRS generally has to employ deficiency procedures, and the Tax Court has jurisdiction. *Id.* (citing I.R.C. § 6230(a)(2)(A)(i); Treas. Reg. § 301.6231(a)(6)-1(a)(3)).

"Affected items" are defined under TEFRA as "any item to the extent such item is affected by a partnership item," I.R.C. § 6231(a)(5), which is frankly less than helpful. To explain the term, the Tax Court offered a concrete example, noting that the deduction for medical expenses is subject to an income-based floor; if a partner had additional income due to an adjustment of a partnership item, her medical expenses would be an affected item because the increase in income would change the floor. 2017 U.S. Tax Ct. LEXIS 17 at *8. The court also explained that "affected items" come in two forms: Computational affected items and factual affected items. *Id.* at *9. Computational affected items can be resolved without the issuance of a notice of deficiency, but factual affected items are generally subject to deficiency procedures because they require a factual determination at the partner level. *Id.* at *10.

Because the case involved a penalty, the court had to address one additional issue: In 1997, Congress amended certain portions of TEFRA and one amendment provided that "the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item" must be determined at the partnership level. I.R.C. § 6221. Congress also excluded penalties that "relate to adjustments to partnership items" from the category of affected items that were subject to deficiency procedures. I.R.C. § 6230(a)(2)(A)(i).

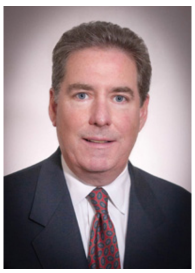
Against that background, the Tax Court focused on "whether the deficiency procedures apply to a section 6662(a) accuracy-related penalty for negligence imposed solely because of a partner's inconsistent reporting of partnership items," 2017 U.S. Tax Ct. LEXIS 17 at *11, as that would control whether it had jurisdiction. First, the Tax Court noted that the penalty, applicable under a provision of subtitle F of the Code was plainly not a partnership item. *Id.* Since it was not a partnership item, the penalty would be subject to deficiency procedures, unless it was a computational affected item. *Id.*

Turning to the specific penalty at hand, the Tax Court noted that historically, negligence-based penalties were subject to deficiency procedures because they required factual determinations concerning the individual partner. *Id.* at *12. Next, the court addressed the impact of the 1997 amendments. While the amendments would normally make the determination of the negligence penalty part of the partnership proceeding, in *Malone*, there had been no partnership level proceeding. As a consequence, there were no adjustments to any partnership items, and the penalty, therefore, did not fall outside the scope of deficiency procedures because it was not "relate[d] to adjustments to partnership items" under section 6230(a)(2)(A)(i). *Id.* at *14.

The Tax Court's logic is hard to fault. While the opinion is difficult to follow at times, that has more to do with the language of TEFRA than the court's efforts to decipher it. The court's holding appears to be a narrow one: The fact that there were no partnership level adjustments controlled the outcome, which suggests that a penalty based upon the failure of an individual partner to treat partnership items on her return in a manner consistent with the partnership return would be dealt with in a partnership proceeding if there were partnership adjustments made.

The other interesting thing about the opinion is that a twenty-year-old amendment to a statute that has been repealed can generate a novel decision.

1 The Malones are not related to the author.



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