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U.S.-Canada Tax Treaty Changes

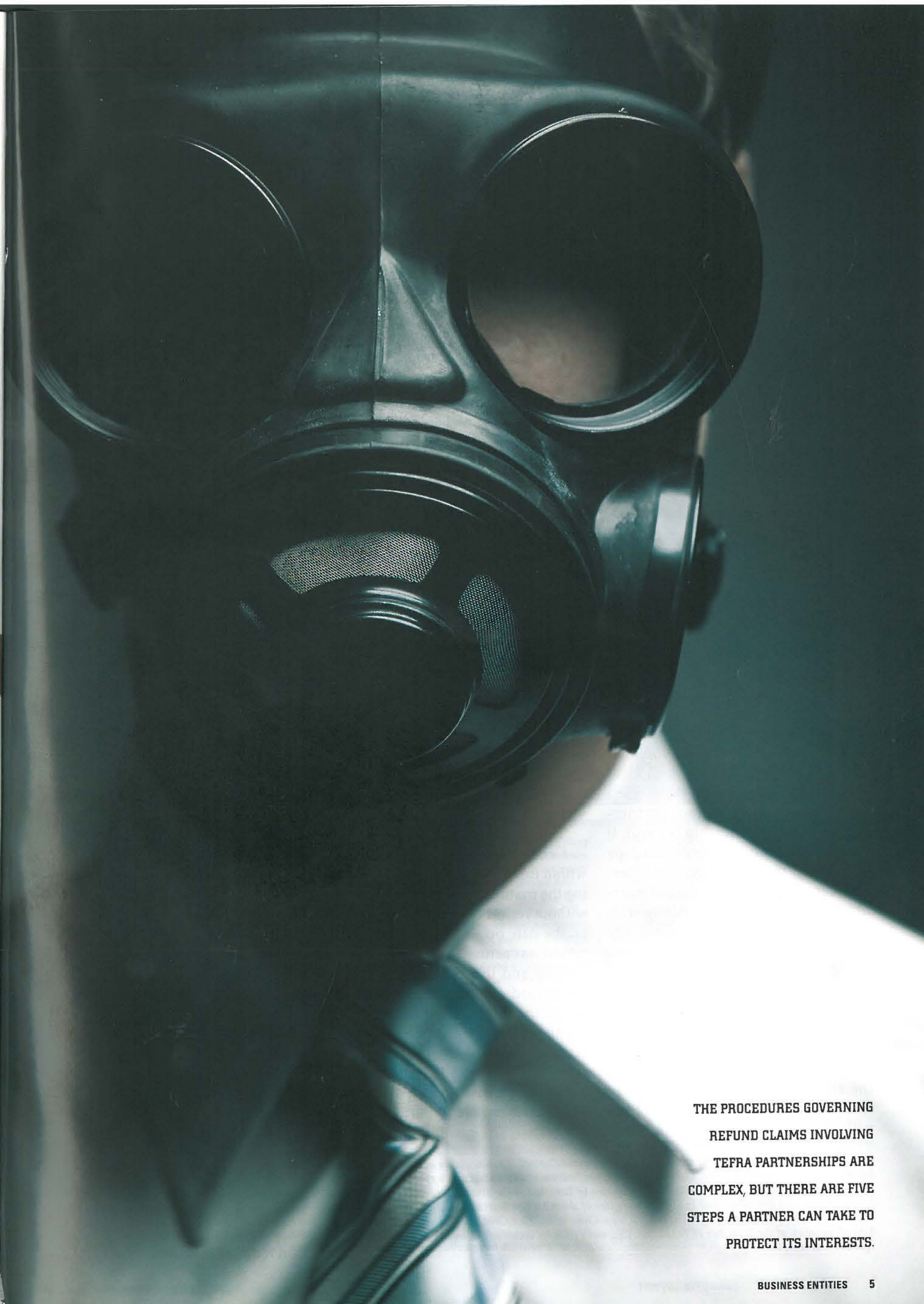
TEFRA-Partnership Refunds

TEFRA-PARTNERSHIP REFUNDS: 5 STEPS TO PROTECT A PARTNER'S RIGHTS

MARY A. MCNULTY, ROBERT D. PROBASCO, AND CARLA C. CRAPSTER

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) established a unified procedure for determining the tax treatment of partnership items at the partnership level rather than the partner level.[1] The TEFRA-partnership refund procedures[2] differ from the refund claim procedures that apply to other taxpayers. For a TEFRA partnership, a refund claim is an administrative adjustment request (AAR) and a notice of deficiency is a notice of final partnership administrative adjustment (FPAA). Procedures for the assessment of additional tax attributable to partnership items have received much attention in recent years, but the procedures concerning refunds are complex and full of traps.

The tax matters partner (TMP) plays a key role in protecting the partners' rights, but the TMP's interests may differ significantly from those of other partners. Because of potential conflicts of interest, an individual partner should not rely entirely on the TMP. This article recommends five steps a taxpayer should


THE PROCEDURES GOVERNING
REFUND CLAIMS INVOLVING
TEFRA PARTNERSHIPS ARE
COMPLEX, BUT THERE ARE FIVE
STEPS A PARTNER CAN TAKE TO
PROTECT ITS INTERESTS.

take to protect its rights to refunds in a TEFRA partnership:

1. File an AAR before the IRS issues an FPAA—otherwise it will be too late.
2. Review the statutes of limitations for AARs carefully, as they differ from other limitations periods.
3. File a separate AAR and do not rely entirely on the AAR filed by the TMP.
4. Consider extending the partner-level statute of limitations for assessments to avoid forfeiting potential refund claims.
5. If beyond the period of limitations, consider alternative methods of recovery.

Overview of AAR Requirements

Any partner may file an AAR on its own behalf,[3] but the AAR will apply only to that partner—other partners cannot rely on it.[4] Alternatively, the TMP can file an AAR on behalf of the partnership.[5] Such an AAR will, if allowed by the IRS or upheld by a court, result in adjustments for all partners. As noted below, however, an AAR filed by the TMP on behalf of the partnership may not adequately protect other partners' rights.

Partners use Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR), to file an AAR. The partner must file a separate Form 8082 for each partnership and each partnership tax year. If the TMP files the AAR, only one copy is required to be filed with the service center where the original partnership return was filed. Along with the Form 8082, the TMP must file revised schedules showing the effects of the proposed changes on each partner and an explanation of the changes.[6] Typically, these revised schedules consist of amended Forms 1065. If an individual partner files an AAR, it must file the Form 8082 (with the relevant schedules and explanation) in duplicate. One copy is filed with the service center where the original partnership return was filed. The partner files the other copy with its own amended income tax return, computing and showing the change in the partner's tax liability if the AAR is granted.[7]

In response to a partner's AAR, the Service can either:

1. Process the AAR in the same manner as a refund claim for nonpartnership items,[8] thus allowing the partner to file a non-TEFRA refund suit if the claim is not allowed.
2. Assess additional tax, if any, resulting from the requested adjustments.[9]
3. Notify the partner that all of the partner's partnership items for the partnership tax year will be treated as nonpartnership items,[10] thus allowing the partner to proceed under non-TEFRA procedures.
4. Audit the partnership.[11]

The TMP also may file an AAR on behalf of the partnership and request that the treatment on the AAR be substituted for the treatment on the partnership's return.[12] The IRS can either:

1. Accept the substituted return and adjust all partners' liabilities as the correction of mathematical or clerical errors.[13]
2. Allow resulting credits or refunds to all partners without conducting a partnership-level proceeding.[14]
3. Audit the partnership.[15]
4. Do nothing,[16] in which case the TMP could file for judicial review.[17]

Generally, partners can file an AAR within three years of the last day for filing the partnership return (determined without regard to extensions) or, if later, the date on which the partnership return was actually filed.[18] If the partnership and the IRS agree to extend the period of limitations for assessments, the period of limitations for filing an AAR is extended for six months after the period of limitations for assessments expires.[19] If the IRS does not allow the AAR in full, the partner who filed it can file a petition for judicial review. The petition must be filed at least six months, but no later than two years, after filing the AAR.[20]

After the IRS or a court adjusts partnership items, the IRS mails a notice of computational adjustment to each partner reflecting the changes to their returns. The IRS applies the adjustments to all partners who do not request, within 60 days, that the correction not be made.[21] If the IRS fails to make the corrections, or calculates them incorrectly, the partner can file a claim for refund.[22]

As discussed more below, many wrinkles and open issues remain in applying these periods of limitations. Therefore, it is recommended that a partner take five steps to protect its rights most fully.

File an AAR Before the IRS Issues an FPAA

Before the IRS proposes adjustments, taxpayers can simply request refunds, whether by a refund claim or AAR. Different procedures apply to taxpayer-initiated adjustments once a notice of deficiency or its equivalent, an FPAA, is issued. The different procedures create a potential pitfall to TEFRA-partnership taxpayers. Outside of the TEFRA-partnership context, the IRS issues a notice of deficiency when it determines that the tax properly due is more than that previously reported or assessed.[23] The taxpayer can file a petition with the Tax Court to redetermine the deficiency[24] or, alternatively, wait for the assessment, pay the assessed amount, and then pursue a refund. To do so, the taxpayer files a refund claim.[25] If the claim is not allowed, that taxpayer may file a refund suit in district court or the Court of Federal Claims.[26]

The TEFRA procedures are quite different, so a taxpayer must be careful not to unwittingly waive its rights. Once the IRS issues an FPAA, partners may no longer file an AAR.[27] Instead, the TMP or, if it fails to do so, any other partner may file a petition for a readjustment of partnership

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1 The complex TEFRA procedures apply to all partnerships with certain exceptions. A partnership with ten or fewer partners, each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner, is not subject to TEFRA procedures unless it so elects. See Section 6231(a)(1)(B).

2 Sections 6221 through 6234.

3 Section 6227(a).

4 Samueli, 132 TC 336 (2009) ("TEFRA also allows each partner to file a partner AAR *solely on behalf of that partner*.") (emphasis added).

5 Section 6227(c).

6 Reg. 301.6227(c)-1.

7 Reg. 301.6227(d)-1. As set forth in the regulations, the requirements for an AAR, whether filed by the TMP or an individual partner, use the word "shall." The IRS, at its discretion, and courts may allow an amended return that substantially complies with the requirements for an AAR. E.g., FSA 557, 10/21/1992; FSA 565, 11/4/1992; Samueli, *supra* note 4, at pages 344-345 ("We agree with petitioners that their amended return, filed without a Form 8082, may be characterized as a partner AAR if it substantially complied with the requirements for a partner AAR. We disagree with petitioners, however, that their amended return substantially complied with those requirements."). Other courts have been less forgiving. E.g., Hamdan, 103 AFTR2d 2009-1303 (Fed. Cl. Ct., 2009) ("The filing of a Form 1040X does not meet the requirements for filing an AAR. The tax regulations require a partner to use the correct form when filing an AAR."); Rothstein, 81 AFTR2d 98-2132 (Fed. Cl. Ct., 1998) ("Because the regulations prescribe the use of a specific form to request administrative adjustment of a partnership's tax treatment, partners seeking a refund of a partnership item *must* use that form. The use of 'shall' in the regulation is 'the language of command' directing strict compliance with the regulation.").

8 Section 6227(d)(1).

9 Section 6227(d)(2). Thus, the IRS would not have to issue an FPAA or notice of deficiency if a partner files an AAR resulting in additional tax due.

10 Section 6227(d)(3).

11 Section 6227(d)(4).

12 Section 6227(c)(1).

13 Section 6227(c)(1). This would typically be the case when the AAR resulted in additional tax to some or all of the partners and no refunds to any of the partners. Normally, the IRS cannot assess tax resulting from the adjustment of partnership items without a partnership-level proceeding. Section 6225. That restriction does not apply to the correction of mathematical or clerical errors, see Section 6230(b)(1). But in the case of an AAR submitted by the TMP, within 60 days after the notice of correction is mailed, a partner can file a request that the correction not be made with respect to that partner. See Section 6230(b)(2). Thus, the TMP cannot unilaterally force a deficiency on other partners who disagree with the AAR without allowing them an opportunity to contest the adjustments.

14 Section 6227(c)(2)(A)(i). This option is not available with respect to a partner for whom the partnership item has already been converted to a nonpartnership item. See Section 6227(c)(2)(B).

15 Section 6227(c)(2)(A)(ii).

16 Section 6227(c)(2)(A)(iii).

17 Section 6228(a). Only the TMP, and no other partner, may file a petition for judicial review of an AAR filed by the TMP.

18 Section 6227(a)(1).

19 Section 6227(b).

20 Sections 6228(a)(2)(A) and (b)(2)(B)(i).

21 Section 6230(b).

22 Section 6230(c).

23 Section 6212.

24 Section 6213.

25 Section 6511.

26 Section 7422; 28 U.S.C. sections 1346(a)(1) and 1491.

27 Section 6227(a)(2).

items in response to the FPAA.[28] The court in which the petition is filed has jurisdiction to determine all partnership items,[29] so the taxpayer can litigate items totally unrelated to the FPAA.[30] In effect, this procedure is an adequate alternative to filing an AAR,[31] but it is the taxpayer's only alternative for pursuing refund items once the IRS issues the FPAA and comes with quicker deadlines. A TEFRA partnership does not have the option of paying the amount in the FPAA and then filing a claim for refund within the next two years.[32]

Review the Statutes of Limitations for AARs Carefully

STEP 2

There are some key differences between the statutes of limitations for filing an AAR and refund statutes of limitations for non-TEFRA-partnership taxpayers. A partner who assumes that the AAR limitations periods follow familiar patterns may be unpleasantly surprised. As the law concerning the statute of limitations for assessments is important in understanding the AAR limitations periods, it is addressed first.

Statute of limitations for partnership-item assessments. The general requirement for non-TEFRA-partnership taxpayers is that the Service must assess additional tax within three years from when the return is filed.[33] The TEFRA procedures include a separate limitations provision for assessments relating to partnership items. With some exceptions, the TEFRA period for assessing tax that is attributable to any partnership items (or affected items) "*shall not expire before*" three years after the later of the date the partnership return was filed or the last day for filing the return (determined without regard to extensions).[34] Congress did not explain exactly how—if at all—the second limitations period (the "Section 6229 period") relates to the first limitations period (the "Section 6501 period"). Is an assessment of additional tax to the partner, related to partnership items, timely if issued after the partnership-level Section 6229 period expires but before the partner-level Section 6501 period expires?

The Service adopted a "statute extension" theory, under which the TEFRA procedures merely extend the Section 6501 period for assessments related to partnership items. An assessment of tax attributable to a partnership item is timely as long as the partner's Section 6501 period is open, even if the partnership's Section 6229 period has expired.[35] In 2000, based on the "shall not expire before" language quoted above, the Tax Court agreed with the IRS. The Tax Court concluded that the two sections provide "alternative periods within which to assess tax with respect to partnership items, with the later-expiring period governing in a particular case."[36]

Since then, several other courts have agreed with this conclusion.[37] The Court of Federal Claims expressed an important aspect of the relationship between the two sections:

> Section 6229(a), however, does not establish an independent limitations period, but rather contemplates a modified limitations period for assessing taxes, i.e., that period described in section 6501(a), and declares that this period "shall not expire before." 26 U.S.C. § 6229(a). References to "the period," read in context with the language of sections 6229(a) and 6501(a), *describe only the limitations period set forth in section 6501(a), as modified* by the minimum period established in section 6229(a).[38]

The Fifth Circuit reached the same conclusion.[39] The only specific reference to "period" in Section 6229(a) is "the period for assessing any tax imposed by subtitle A with respect to any person which is attributable to any partnership item." Thus, a reference to "the period of limitation prescribed in section 6229" is properly interpreted as a reference to the Section 6501 period (as extended).

Statute of limitations for filing an AAR. Section 6227 requires an AAR to be filed within three years from when the partnership return was filed or within an extended period agreed on by the partnership and the IRS.[40] Taxpayers may reasonably assume that the TEFRA limitations period for filing an AAR set forth in Section 6227 is interpreted similarly to the period of limitations for assessments: a partner can file an AAR even if the partnership-level Section 6227 period has expired, as long as the general limitations period for filing partner-level refund claims set forth in Section 6511 is still open. These limitations periods may be different,[41] unless the partner extends its own statute of limitations for partnership items.[42] The IRS has never addressed the interaction of the partner-level and the partnership-level limitations period in the context of AARs, and the only court to consider the issue has rejected the "statute extension" theory. As a result, an AAR filed after the partnership-level limitations period expires may be untimely even though the partner-level limitations period remains open.

McFerrin. McFerrin[43] was an erroneous refund suit[44] by the government concerning the Section 41 research credit for the 1999 tax year. The husband taxpayer was the sole shareholder of four S corporations, two of which were the sole partners in a partnership. The partnership filed its return in July 2000, and the S corporations filed their returns in March and May 2000. The taxpayers filed their personal income tax return on 10/13/2000. None of the original returns claimed the Section 41 research credit.

The partnership filed an amended return on 9/22/2003, to claim the research credit, and the partner S corporations filed amended returns in September 2003 claiming the research credits that flowed through from the partnership. The other two S corporations filed amended returns in September 2003 based on their own research expenditures, and the taxpayers filed an amended return in September 2003. The IRS paid a $472,092 refund on 11/7/2003, based on these amended returns. In 2005, the IRS filed an erroneous refund suit on the basis that the refund was issued after the limitations period had expired. The parties agreed that the initial amended returns filed in September 2003 by the taxpayers and the nonpartner S corporations were timely filed because the taxpayers had filed their original return in October 2000.[45] The IRS contended, how-

[28] Section 6226(a), (b). Partners can choose to bring the action in the Tax Court, a district court, or the Court of Federal Claims.

[29] Section 6226(f).

[30] Reg. 301.6226(f)-1(a) ("Thus, the review is not limited to the items adjusted in the notice."). Similarly, a refund claim and refund suit filed after a notice of deficiency is issued are not limited to the specific items included in the notice of deficiency, so the taxpayer can recover overpayments of tax from totally unrelated items.

[31] At least one taxpayer tried unsuccessfully to use this alternative as a way around the statute of limitations restrictions described below. In Atlantic Richfield Co., 79 AFTR2d 97-585 (DC D.C., 1996), the statute of limitations for filing an AAR expired before the IRS began auditing the partnership. The IRS initially identified proposed adjustments for $800 million in additional deductions and tax credits that the partnership failed to claim on its tax return but then decided not to issue an FPAA. The partner sought an order compelling the IRS to issue a "no change" FPAA, which would permit the partners to file a petition for readjustment to claim the additional deductions and tax credits. The court denied the motion for a temporary restraining order because it was prohibited by the Anti-Injunction Act, and the likelihood of success on the merits was insubstantial, as there is no statutory requirement to issue FPAAs.

[32] Section 6511(a).

[33] Section 6501(a).

[34] Section 6229(a) (emphasis added).

[35] FSA 2167 (9/3/1997).

[36] Rhone-Poulenc Surfactants & Specialties, L.P., 114 TC 533 (2000).

[37] See, e.g., Curr-Spec Partners, L.P., 579 F.3d 391, 104 AFTR2d 2009-5894 (CA-5, 2009), *cert. den.* 130 S. Ct. 3321 (2010); AD Global Fund, LLC, 481 F.3d 1351, 99 AFTR2d 2007-1259 (CA-F.C., 2007); Andantech LLC, 331 F.3d 972, 91 AFTR2d 2003-2623 (CA-D.C., 2003); Schumacher Trading Partners II, 72 Fed. Cl. 95, 98 AFTR2d 2006-5712 (Fed. Cl. Ct., 2006); Grapevine Imports, Ltd., 71 Fed. Cl. 324, 97 AFTR2d 2006-2936 (Fed. Cl. Ct., 2006).

[38] Schumacher Trading Partners II (emphasis added), *supra* note 37. See also AD Global Funds, LLC ("Because § 6229 does not state an end date or otherwise set forth a maximum period, it does not, on its face, create a statute of limitations."), *supra* note 37.

[39] Curr-Spec Partners ("For partnership items, the otherwise applicable limitations period of IRC § 6501(a) '*shall not expire before* the date which is 3 years after the later of ... the date on which the partnership return ... was filed' or the date on which it was due." (quoting Section 6229(a)) (emphasis in original)), *supra* note 37.

[40] If the partnership and the IRS do not extend the statute of limitations, individual partners can extend their partner-level statute of limitations for assessments with respect to partnership items. See *infra* discussion under Step 4.

[41] Although the two statutes of limitation are worded similarly, they are not identical. Section 6227 is based on when the partnership's return was filed, while Section 6511 is based on when the partner's return was filed. Partners' returns are usually filed after the partnership's return, because a partner needs its Form K-1 before filing its return. As a result, a partner's three-year period of limitations for filing refund claims usually begins to run at a later date than the period of limitations for filing an AAR.

[42] If the partner extends its own statute of limitations for assessments with respect to partnership items, both the partner-level statute of limitations for refund claims (Section 6511(c)(1)) and the partnership-level statute of limitations for filing an AAR (Section 6227(b)) would be identical. See *infra* discussion under Step 4 concerning a partner-level extension.

[43] 492 F. Supp.2d 695, 99 AFTR2d 2007-2979 (D.C. Tex., 2007).

[44] Section 7405.

[45] The court noted that a shareholder's filing commences the limitations period on a nonfiling corporation, citing in support Bufferd, 506 U.S. 523, 71 AFTR2d 93-573 (1993) (which referred to the limitations period on assessments, which the court found analogous to the case at bar). The court stated that this was also the effective filing date for each of the S corporations.

ever, that the partnership's amended return filed in October 2003 was untimely because the partnership had filed its original return in July 2000.

The court agreed that the partnership's amended return was untimely. Although the court did not expressly address the statute extension theory, the result implicitly suggests that the only relevant period is the Section 6227 period.

McFerrin is the only case addressing this issue, and it is unknown whether other courts would reach the same conclusion. Although symmetry suggests that the same statute extension theory should apply to refund claims, Section 6227 does not include the same "shall not expire before" language as Section 6229. Therefore, the statute extension argument is weaker for filing an AAR, and a taxpayer should not intentionally rely on it. Instead, a TEFRA partnership and its partners should aim to file an AAR within three years from when the partnership return was filed or within the extended time period as agreed on by the partnership and the IRS.[46]

Statute of limitations for allowing a refund. In addition to the statute of limitations for filing an AAR, there is a second limitations period that is relevant to refunds. Section 6230(d)(1) limits when the IRS may allow partners credits or refunds of overpayments attributable to partnership items:

> Except as otherwise provided in this subsection, no credit or refund of an overpayment attributable to a partnership item (or an affected item) for a partnership tax year shall be allowed or made to any partner after the expiration of the period of limitation prescribed in section 6229 with respect to such partner for assessment of any tax attributable to such item.[47]

Section 6230(d)(1) was most likely enacted because the IRS may allow refunds to partners for partnership items even without AARs. For instance, the IRS may allow a refund as a result of a computational adjustment or as the result of an audit or resolution of an FPAA.

The *McFerrin* taxpayers conceded that the Section 6227 period had expired, but they argued that the partnership's amended returns were still timely because:

1. The Section 6230(d)(1) limitations period is based on the Section 6229 period and therefore on the Section 6501 period.[48]
2. An AAR would still be timely if filed while the Section 6230(d)(1) period was open, even though the Section 6227 period had expired.

The court did not explicitly adopt or reject the second part of this argument, but it rejected the first part. Under the plain language of Section 6229(a), the limitations period for assessment of partnership items expires three years after the partnership return is filed. Although Section 6229(a) operates in conjunction with Section 6501, "Section 6229 sets out a minimum period—three years—during which the IRS may make tax assessments on partnership items, while § 6501(a) prescribes a three year period as the maximum period for the IRS's assessments." This analysis, however, is inconsistent with other authorities,[49] which interpret "the period of limitation prescribed in section 6229" as a reference to the Section 6501 period as extended by Section 6229. The Service reached the same conclusion in a Field Service Advice.[50] Thus, Section 6230(d)(1) allows refunds as long as the statute of limitations for assessment under Section 6501 is open.

The statute of limitations for allowing a refund does not apply to filing an AAR, however. In a Field Service Advice, the IRS, while interpreting the statute of limitations for allowing a refund, stated:

The IRS has never addressed the interaction of the partner-level and the partnership-level limitations period in the context of AARs.

46 See *supra* text accompanying note 40.

47 There are several exceptions to this general rule; see Sections 6230(c), (d)(2), and (d)(3).

48 In support of their position, the taxpayers cited Rhone-Poulenc, Grapevine Imports, and Andantech, see *supra* notes 36 and 37.

49 See *supra* notes 38 and 39 and accompanying text.

50 "Section 6230(d)(1) does not prohibit the issuance of a refund or credit attributable to such partnership items. Although section 6230(d)(1) prohibits issuance of a refund or credit after the period 'prescribed under section 6229,' the referenced period in section 6220 is section 6501. Since this period remains open, the period for issuing refunds also remains open under section 6230(d)(1)." FSA 2102, 5/20/1997 (citations omitted).

51 FSA 1999-871 (emphasis added).

52 "Section 6230(d)(5) also clearly contemplates that some refunds under TEFRA will not be made in this manner. Specifically, Section 6230(d)(5) provides that such refunds will be made only 'to the extent practicable ...' Accordingly, whether a claim under this section is required without a refund request is contingent on the Government's determination that such a refund is practicable. Furthermore, although Section 6230(d)(5) does conditionally obligate the Government to issue refunds without claims, Section 6230(c)(1)(B) establishes that a refund claim be filed in the event the refund is not issued automatically. Thus, TEFRA explicitly provides the appropriate procedure should the refund not be made pursuant to Section 6230(d)(5). Because of the contingent nature of this provision, as well as the procedures for filing claims outlined in TEFRA, the Court finds that TEFRA does not constitute an exception to the general jurisdictional requirement contained in 26 U.S.C. § 7422(a)." Whittington, 380 F. Supp.2d 806, 96 AFTR2d 2005-5201 (DC Tex., 2005) (citations omitted).

53 Section 6532.

54 Sections 6228(a)(2)(A) and (b)(2)(B)(i).

55 Section 6226(c).

56 Section 6226(b)(1).

57 Section 6228(a).

58 See *supra* note 4. The IRS might allow a refund under Section 6230(d)(5), but that option is at its discretion. See *supra* note 52.

59 The TEFRA procedures include no restriction for AARs comparable to Section 6226(b), for example, which allows other partners to file a petition for readjustment of partnership items with respect to an FPAA "[i]f the tax matters partner does not file a readjustment petition." See also FSA 587, 2/2/1993 (discussing that both the TMP and limited partners filed AARs for the same partnership tax year); CCA 200908031 ("All of the AARs, both by the TMP under Section 6227(c), and by the individual partners under Section 6227(d), may be treated as valid.").

60 CCA 200908031 ("I would suggest denying the individual claims on the basis that the claimed adjustments will be considered exclusively in the context of the TMP AAR.").

61 Section 6228(b)(2) applies to judicial review of AARs filed by individual partners under Section 6227(d), while Section 6228(a) applies to judicial review of AARs filed by the TMP under Section 6227(c).

62 Section 6229(b)(1)(B).

63 Section 6227(b).

64 Section 6229(b)(1)(A). A partner would use Form 872 (which includes language specifically addressing partnership items) for an extension, while the partnership would use Form 872-P.

If the statute extension theory were to apply, it would apply to section 6230(d)(1) which prohibits refunds after the period under section 6229(a) has expired. In referring to section 6229, it can be argued that section 6230 refers to section 6501 as extended under section 6229(a). Thus, the Service, *at its discretion*, could arguably issue an FPAA or enter into a settlement agreement for partnership items since the period of limitations would be open under this theory. *The taxpayers probably have no affirmative right to seek a refund*, however . . . .[51]

Under this interpretation, the IRS could still allow a credit or refund of an overpayment attributable to a partnership item within the Section 6230(d)(1) period, but the filing of an AAR after the Section 6227 period had expired would not be timely. Thus, an adjustment would be at the IRS's discretion because the taxpayer would not have the right to judicial review under Section 6228.[52]

Statute of limitations for judicial review. Even after an AAR has been timely filed, one further statute of limitations trap awaits. Outside the TEFRA context, taxpayers can file a refund suit within two years after a refund claim is disallowed.[53] A cursory reading of the procedures might lead to the assumption that the same rule applies within the TEFRA context, but it does not. A partner or partnership must file suit contesting the disallowance of an AAR not within two years of the disallowance of the claim, but within two years of the date the AAR was filed.[54]

Two essential points. First, do not assume that a partner can still file an AAR as long as the partner-level statute of limitations for assessment and refund claims is still open. While the partner-level statute of limitations allows the Service to make assessments of tax attributable to partnership items even after the partnership statute has closed, a similar rule does not apply to refunds. Therefore, a partner needs to file an AAR within three years after the partnership return is filed (or within the agreed extended period of limitations)—a partner should not wait until three years after the partner's return is filed.

Second, do not assume that the statute of limitations for going to court remains open indefinitely if the Service does not formally disallow the AAR. That may be how things work for nonpartnership items, but it does not apply to partnership items. A partner needs to file a petition for judicial review within two years from when the AAR was filed.

File a Separate AAR

STEP 3

When a TMP files a petition for judicial review of an FPAA, the individual partners cannot also file a petition, but they automatically become parties to the petition filed by the TMP.[55] If the TMP does not file a petition for redetermination of an FPAA, however, any individual partner may file suit.[56] Thus, no partner is ever barred from contesting an FPAA due to the TMP's failure to act.

If only the TMP files an AAR and the IRS disallows it, only the TMP has the right to file a petition for an adjustment to the related partnership items.[57] If the TMP does not file a petition for judicial review, the individual partners cannot do so. The other partners are completely dependent on the TMP if only the TMP files an AAR.

Because one partner is not entitled to an adjustment related to an AAR filed by another partner, no partner can count on receiving a benefit of an AAR filed by another partner.[58] Although an AAR filed by the TMP will protect all other partners, an individual partner never has a guarantee that the TMP will act in its best interest. Individual partners can, however, always file their own AAR, even when the TMP or another partner files an AAR.[59] Although the IRS may reject the duplicative AAR,[60] the partner would still have the right to file a petition for judicial review[61] and not be entirely dependent on the TMP. Thus, it may be in an individual partner's best interests to file its own AAR rather than relying on the TMP or other partners.

Extend the Partner-Level Limitations Period for Assessments

STEP 4

While seemingly counter-intuitive, sometimes it makes sense to extend the statute of limitations for assessment of partnership items to avoid forfeiting potential claims that result from correlative adjustments to a related party.

If the TMP and the IRS execute an agreement to extend the period of limitations for the assessment of tax attributable to partnership items,[62] the statute of limitations for filing an AAR is extended to six months after the period of limitations for assessments ends.[63] If the period of limitations for assessments is not extended, or if more time is needed to identify potential refund items and file an AAR, a partner may file a protective AAR. When the refund claim is perfected, however, the partner will need to prepare a second set of amended returns for both the partnership and itself. In addition, the partner will be concerned about whether the perfected claim would be considered within the scope of the protective claim. To avoid these problems, the partner should consider entering into an agreement with the IRS extending its own period of limitations for assessment with respect to partnership items.[64] The partner then would not be dependent on the TMP agreeing to an extension.

There are two drawbacks to a partner agreeing to extend the period of limitations for assessments:

1. The extension agreement will allow the IRS more time to conduct an audit of the partnership and to identify adjustments that may more than offset any potential refund items. A partner needs to evaluate its exposure carefully before deciding to extend the statute of limitations.
2. The IRS must agree to the extension. The IRS's policy is not to agree to an extension unless it is to the government's benefit. The Internal Revenue Manual states:

(1) The Service does not secure consents extending the period for assessment in cases involving claims or overassessments unless final disposition will possibly result in a deficiency or additional tax.

...

(3) If there is no possibility of a deficiency in an overassessment case, advise the taxpayer in writing about protecting his or her interest by filing a protective claim for refund.[65]

While there is no guarantee that the IRS will agree to an extension, it is an option that a partner should consider.

Consider Alternative Methods of Recovery

STEP 5

There are methods other than AARs or refund claims that partners may consider to recover an overpayment of taxes attributable to partnership items if, for some reason, an AAR or petition for judicial review is not available.

Section 6230(d)(5) adjustment. As noted above, the IRS is directed to allow a credit or refund of a partner's overpayment attributable to a partnership item, even without a claim by the partner. FSA 1999-871 and FSA 2102, discussed above, provide authority for such an adjustment at any time when the Section 6501 limitations period for assessment is open. These adjustments are at the IRS's discretion when the partner did not file a timely AAR or petition for judicial review, but if a partner is beyond the limitations periods for filing an AAR or a petition for judicial review, it can request that the IRS make a discretionary adjustment.

Equitable recoupment. Some potential refund items might relate to transactions between the partnership and a related party in which the partner also has an interest. For example, a transfer pricing adjustment in an audit of a related party might give rise to a refund item for the partnership and its partners. If so, there may be grounds for equitably recouping the barred refund adjustment to the partnership return against the assessment of the related party.

Equitable recoupment is a judicial doctrine that allows the recovery of amounts otherwise barred by the statute of limitations under certain conditions:

> First, a single transaction must be the taxable event to be considered in recoupment. Second, the single transaction must be subject to two taxes based on inconsistent legal theories. Finally, the statute of limitations must bar recoupment, while either the government's asserted deficiency or the taxpayer's claim for a refund must be timely.[66]

Although equitable recoupment normally applies when a single transaction is subject to two taxes imposed on the same taxpayer, it has been extended in some instances to separate taxpayers "where there is a clear identity of interests between them, such that the benefits and detriments to one party inure exclusively to the other."[67] Examples include an estate and the sole beneficiary of the estate,[68] a corporation and its sole shareholder,[69] and a decedent's estate and the family members to whom she transferred interests in a family limited partnership.[70] Courts and the IRS have rejected other situations involving separate taxpayers, because they considered the identity of interests insufficient. These situations include two corporations owned by the same sole shareholder,[71] a taxpayer and her sister,[72] and a husband's estate and his widow (because there were other beneficiaries of the husband's estate).[73]

Although the IRS requires that the benefits and detriments inure exclusively to the second taxpayer, at least one court has allowed equitable recoupment when there was not a complete identity of interests. In *Estate of Buder*,[74] the husband's will created a residuary trust for the benefit of his wife and children. The husband's estate claimed a marital deduction for the residuary trust as qualified terminable interest property (QTIP). When the wife died, her estate initially included the value of the residuary trust but later claimed a refund on the basis that the QTIP election by the husband's estate was improper and the trust, therefore, should have been taxed as part of his estate.

Even though the beneficiaries of the husband's estate and the beneficiaries of the wife's estate were not exactly identical, the court allowed equitable recoupment to reduce the refund due the wife's estate by the underpayment of tax by the husband's estate. The court did not grant full recoupment, however, because the beneficiaries of the husband's estate were not exactly the same as the beneficiaries of the wife's estate. Some of the beneficiaries who benefited from the deduction claimed by the husband's estate would not benefit from a refund received by the wife's estate. The court reduced the recoupment amount by the burden of additional taxes that would have been borne by other beneficiaries if the husband's estate had not claimed a marital deduction for the residuary trust.

While other decisions suggest that a partial identity of interests is insufficient for equitable recoupment,[75] *Estate of Buder* allowed equitable recoupment with only a 55.4% overlap in interests. Therefore, depending on the circumstances, a partner should consider requesting equitable recoupment against the assessment of a related party concerning a transaction between that related party and the partnership.

Mitigation. The mitigation provisions of the Code[76] perform a function similar to the judicial doctrine of equitable recoupment, by allowing the recovery of amounts otherwise barred by the statute of limitations. Equitable recoupment may be available to redress inconsistent treatment of transactions between the partnership and a related party in which the partner also has an interest. Mitigation, however, has different requirements.

When inconsistent positions are taken on the returns of two different taxpayers rather than two different tax years for the same taxpayer, mitigation is available only when the two taxpayers are "related." Under Section 1313(c)(6), "partner" is included in the definition of related taxpayers. That provision is normally interpreted to address the relationship between two partners in a partnership rather than between a partnership and one of its partners.[77] As a result, mitigation usually will apply to inconsistent treatment of transactions between two partners in a partnership, but not between the partnership and its partners.

Conclusion

The TEFRA procedures for AARs provide all partners a way to recover overpayments attributable to partnership items. The procedures are complex, however, with many potential pitfalls. Any partner who identifies a potential refund item for the partnership should thoroughly review all of the applicable requirements and carefully assess what it must to do to preserve its rights. In particular, a partner may find it beneficial to file its own AAR, or include refund items in a petition for readjustment of an FPAA, in case the TMP cannot or will not act in the partner's interests. Under some circumstances, it may even be appropriate for a partner to extend its own statute of limitations to protect its interests. ■

65 IRM 8.7.7.2.2.

66 Catalano, 240 F.3d 842, 87 AFTR2d 2001-874 (CA-9, 2001).

67 TAM 9708002. See generally O'Brien, 766 F. 2d 1038, 56 AFTR2d 85-5395 (CA-7, 1985).

68 Stone v. White, 301 U.S. 532, 19 AFTR 503 (1937).

69 Hufbauer, 297 F. Supp. 247, 23 AFTR2d 69-612 (DC Calif., 1968).

70 Estate of Jorgensen, TCM 2009-66.

71 TAM 9708002 ("Neither [corporation] holds any ownership interest in the other; they merely share the same individual owner. The benefits and detriments to one corporation do not inure exclusively to the other, and the proper payment of the deficiency by B did not affect A.").

72 Owen, 139 F.3d 907, 81 AFTR2d 98-962 (CA-9, 1998).

73 Kramer, 406 F.2d 1363, 23 AFTR2d 69-1836 (Ct. Cl., 1969) ("Mrs. Kramer's personal income benefitted from the income tax refund, but other persons, i.e., the remaindermen, have a vested interest in the residuary estate. If Mrs. Kramer were the sole beneficiary then Stone v. White would be applicable and the defendant would be entitled to an equitable recoupment. Here, however, there is a possibility that the remaindermen will also benefit from the estate tax refund, therefore the doctrine of equitable recoupment is not applicable.")

74 372 F. Supp.2d 1145, 95 AFTR2d 2005-2339 (DC Mo., 2005), *aff'd* 436 F.3d 936, 97 AFTR2d 2006-1065 (CA-8, 2006).

75 See *supra* notes 67 through 73 and accompanying text.

76 Sections 1311 through 1314.

77 E.g., Great Falls Nat'l Bank, 388 F. Supp. 577, 35 AFTR2d 75-742 (DC Mont., 1975) (using mitigation to correct an error in the allocation of partnership income between two partners).