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175 DTR K-1

Passthrough Entities

Court Got It Right on Partner Penalty Defense: Tax Attorneys

By Erin McManus

Sept. 8 — A federal appeals court got it right when it ruled that a managing partner could challenge a tax penalty in a partner-level proceeding, tax controversy attorneys told Bloomberg BNA.

The Sept. 6 decision in *McNeill v. United States* held that retired energy company executive Corbin McNeill's status as managing/tax matters partner in an entity set up for a tax shelter transaction didn't preclude him from pursuing a partner-level defense to the penalty assessed by the Internal Revenue Service as a result of his participation in the transaction (173 DTR K-2, 9/7/16).

McNeill appealed a federal trial court's dismissal of his attempt to obtain a refund of the $7.75 million penalty on the basis that he had reasonable cause for the position he took and that he filed his tax return in good faith based on the opinions of his tax advisers.

In a separate proceeding, McNeill challenged the IRS's disallowance of losses generated by the tax shelter. That case was dismissed on the government's motion without any ruling on the penalty and not reinstated by McNeill.

Snapshot

- Tenth Circuit correctly allowed managing partner chance to make penalty defense, litigators say
- Case shows TEFRA's difficulties, but it is usually taxpayer, not IRS, seeking single-level determination

The U.S. Court of Appeals for the Tenth Circuit "clearly got this issue right. As far as the penalty assertion was concerned, there was no issue preclusion involved and intent for penalty determination purposes is based on the individual's state of mind and their ability to demonstrate reasonable cause and good faith," Lawrence M. Hill, a partner at Shearman & Sterling LLP in New York, told Bloomberg BNA in a Sept. 7 e-mail.

TEFRA Traps

The Tenth Circuit issued the decision under the Tax Equity and Fiscal Responsibility Act (TEFRA), which will be replaced in 2018 with a new partnership tax regime that will allow the IRS to collect taxes at the partnership level. The new regime will do away with the two-level approach under TEFRA in which the IRS conducts audits at the partnership level but collects taxes at the partner level.

Tom Cullinan, a partner at Sutherland Asbill & Brennan LLP in Atlanta, said Sept. 7 that TEFRA will be relevant for many more years with the number of cases in the pipeline, noting that the transaction at issue in *McNeill* occurred in the early 2000s.

"TEFRA, unfortunately, is not always clear about the level at which particular issues must be determined, leading to cases like *McNeill*. In the end, I think the majority got it right, if only because the law on this issue was sufficiently unclear that it was reasonable for Mr. McNeill to believe it appropriate to litigate the reasonable cause defense at the partner level, and interpreting TEFRA to deny him that opportunity would be creating another in the many TEFRA traps for the unwary," Cullinan said.

Brian C. McManus, a partner at Latham & Watkins LLP in Boston, said in a Sept. 7 e-mail that "this case is yet another example of how TEFRA's complex procedures have the potential to swallow up the merits of a case. Here, I think the Tenth Circuit was correct in finding that under TEFRA there is a meaningful distinction between partnership-level and partner-level penalty defenses, even when those defenses are asserted in each case by the managing or tax matters partner."

Dubious Efficiency Argument

Controversies under TEFRA can result in two levels of litigation—first, at the partnership level to challenge IRS adjustments, and then at the partner level to challenge deficiencies and penalties. McNeill paid his penalty and then sued for a refund in the U.S. District Court for the District of Wyoming, claiming he had reasonable cause to take the tax-shelter-generated deductions on his tax return.

In addition to claiming that TEFRA didn't allow a managing partner to bring a partner-level case, the government also argued against allowing a partner-level defense for McNeill on the basis of efficiency. The government usually opposes taxpayer efforts to have penalty issues resolved in a cost-efficient manner, practitioners said.

Hill said the government's argument—that a partnership level determination should be dispositive on the partners and would result in judicial economy—"is a curious and strained rationale, since the position it was arguing here was contrary to the position it has advanced in other litigation when it was to its advantage to assert that the

partner's reasonable cause should be a separate inquiry from the partnership's. Hardly judicially efficient to be litigating this issue because of nothing more than outcome or result orientation."

Costly for Partners

Cullinan said in most cases—particularly in the U.S. Tax Court, where the taxpayer doesn't have to first pay the tax or penalty—it is the partner who wants to raise the reasonable cause defense at the partnership level to avoid the additional expense of partner-level litigation.

Mary A. McNulty, a partner at Thompson & Knight LLP in Dallas, also said in a Sept. 7 e-mail that it is taxpayers who have similarly dealt with inefficiencies of TEFRA for years when suing for a refund as McNeill did.

"Many penalty issues may be raised only at the partner level, following assessment, payment, and the filing of a claim for refund. This procedure can be costly and time-consuming to a partner. Therefore, a taxpayer with limited funds may choose not to contest the partnership-level adjustment and spend its resources defending only the penalty," McNulty said.

Future Issue Preclusion

The Tenth Circuit found there wasn't issue preclusion, because the penalty issue hadn't been decided in the partnership-level proceeding.

"The court suggests that issue preclusion may prevent the tax matters partner from raising the same reasonable cause and good faith defense in a partner-level proceeding that was raised during the partnership-level proceeding. The court has teed up that issue for the IRS to assert in a future case," McNulty said.

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