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Munro Stipulations: TEFRA Timing Mismatches Remain

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In this article, Wood and Shapiro review *Munro v. Commissioner* and the tax community's reaction to it, while discussing the practical solution the IRS used at the conclusion of a partner-level Tax Court proceeding, as well as Congress's legislative override of the *Munro* decision.

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The 1982 Tax Equity and Fiscal Responsibility Act created rules designed to simplify audits involving large partnerships.[1] Essential concepts of the TEFRA rules are "partnership items" and "partnership proceedings." Partnership items are items that Treasury regulations indicate are "more appropriately determined at the partnership level than at the partner level."[2] A partnership proceeding is where partnership items are raised and adjudicated. TEFRA allows the IRS to adjust partnership items that can be resolved at the partnership level, rather than in multiple and separate proceedings with each partner.

This sounds simple. So did section 338 elections. Indeed, fundamental complexities remain despite the TEFRA simplification effort. Timing mismatches persist between adjustments at the partnership level and for the partner. Timing mismatches occur because partnership and non-partnership items cannot be considered in the same proceeding.[3] This was (and remains) a tricky issue because partnership-level cases usually proceed slower than partner-level cases.[4] As a result, adjustments at the partner level may need to be made before related adjustments to partnership items can be finally determined in a partnership proceeding.

In the early years after TEFRA, it was not clear how partnership items could be taken into account when computing a partner's tax deficiency, or vice versa. Before 1989 the IRS would generally compute deficiencies for individual partners by assuming that all partnership items were correctly reported.[5] When a taxpayer was "oversheltered" (losses from partnership items offset any proposed adjustment to non-partnership items), the Service issued a notice of deficiency disallowing those partnership items for computational purposes only.[6]

In 1989 this practice changed following the Tax Court's decision in *Munro v. Commissioner*.[7] It required the IRS to stop disallowing partnership items in the case of oversheltered partner returns. This article gives a brief overview of *Munro* and the tax community's initial reaction to it. The article also discusses the practical solution the Service employs at the conclusion of a partner-level Tax

[1]Section 6221 *et seq.*

[2]Section 6231(a)(3). Common examples of those items include each partner's share of the partnership's income, gain, loss, deductions, credits, nondeductible expenditures, and liabilities; and the factors that underlie the determination of those amounts. Reg. section 301.6231(a)(3)-1(a)(1)(i) and (ii). Penalties and other additions to tax are also considered partnership items to the extent they relate to partnership items. Reg. section 301.6231(a)(3)-1(a)(1)(v).

[3]H.R. Rep. No. 97760, 97th Cong., 2d Sess. (1982).

[4]Testimony of Abraham Shashy, IRS chief counsel, Before the House Subcommittee on Select Revenue Measures (July 29, 1991).

[5]*Id.*

[6]Treasury, "Widely Held Partnerships: Compliance and Administration Issues, a Report to the Congress" (Mar. 30, 1990).

[7]92 T.C. 71 (1989).

Court proceeding (the *Munro* stipulation), as well as Congress's legislative override of the *Munro* decision (section 6234).

As discussed below, the *Munro* stipulation nominally allows the IRS and the partner to await the outcome of the partnership proceeding before applying partnership item adjustments to the partner's return. Although it may have solved one problem, it created another. Indeed, the current text of the *Munro* stipulation only extends the statute of limitations for ''computational adjustments'' arising from the determination of partnership items in the partnership proceeding. A computational adjustment is a ''change in the tax liability of a partner which properly reflects the treatment . . . of a partnership item.''[8] However, the text of the *Munro* stipulation may inadvertently allow the partner's statute of limitations for partnership items to expire in some cases (such as when the consent of the tax matters partner (TMP) to extend the statute of limitations later turns out to be invalid for any reason).

The tax code requires that any agreement to extend the statute of limitations for partnership items must expressly provide for such an extension.[9] The *Munro* stipulation does not. If the IRS wishes to avoid having the partner's statute of limitations for partnership items expire for cases in which a *Munro* stipulation is used, it should consider amending the language of *Munro* stipulations to expressly provide for an extension regarding partnership items.

Munro v. Commissioner

The Tax Court's 1989 decision in *Munro* temporarily put a stop to the Service's practice of disallowing partnership items when doing partner-level calculations of oversheltered returns.[10] In *Munro*, the IRS increased non-partnership income, but not enough to completely offset the reported net loss.[11] The IRS then issued a statutory notice of deficiency by disallowing the partnership losses.[12]

The taxpayers in *Munro* challenged the deficiency in Tax Court on the grounds that the IRS had improperly considered adjustments to partnership income before the partnership audits had been concluded.[13] The IRS countered by arguing that the accuracy of the proposed adjustments to the Munros' partnership items could be assumed for purposes of computing the taxpayers' deficiency from the adjustment of the non-partnership items.[14]

The Tax Court rejected the Service's arguments. In determining whether a deficiency at the partner level exists, the court held, the IRS cannot take into account partnership items that are subject to a separate and ongoing TEFRA partnership proceeding.[15] However, if the taxpayers had prevailed, the partnership losses would have entirely offset the proposed adjustment to non-partnership items. There would have been no deficiency and the Tax Court would not have had jurisdiction.[16] The court also rejected the taxpayers' argument that there was no deficiency and that the Tax Court therefore had no jurisdiction.[17] The court stated:

> While we reject respondent's argument that proposed adjustments to partnership items can be taken into account in computing a deficiency, we nevertheless agree that if all of petitioners' [tax year] 1983 partnership items are ignored, respondent has determined a deficiency. Notwithstanding the existence of a deficiency, the deficiency determined by respondent does not correlate with the deficiency that arises out of his adjustments to nonpartnership items, and only the deficiency attributable to nonpartnership items can be at issue in this case. As to the balance, the deficiency, if any, must await the outcome of the partnership proceedings.[18]

Initial Reactions

Initial commentary on *Munro* noted that the decision created problems for both the IRS and taxpayers.[19] For the IRS, *Munro* created an administrative burden because the *Munro* computations it requires are more complex than simply disallowing the partnership losses.[20] For partners with oversheltered returns, they must now wait to obtain the benefit of partnership losses until those losses are

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[8]Section 6231(a)(6).
[9]Section 6229(b)(3).
[10]*Munro*, 92 T.C. at 73-75.
[11]*Id.*
[12]*Id.*
[13]*Id.* at 72-73.
[14]*Id.* at 73.
[15]*Id.* at 74-75.
[16]John S. Pennell, ''Pennell Submits Discussion of Partnership Decision'' (June 19, 1990).
[17]*Munro*, 92 T.C. at 73-75.
[18]*Id.* at 74.
[19]Joint Committee on Taxation, ''Staff Explanation of Title II, Treatment of Large Partnerships, of the 'Tax Simplification Act of 1991,''' JCX-8-91 (June 26, 1991); Lee A. Sheppard, ''A Look at the Partnership Provisions of H.R. 11,'' *Tax Notes*, Oct. 5, 1992, p. 15; Statement of Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of Treasury, Before the Subcommittee on Taxation Committee on Finance United States Senate (Sept. 10, 1991) (''The opinion in *Munro* creates problems for both the IRS and taxpayers'').
[20]A detailed example of a *Munro* computation can be found in section 8.19.4-28 of the Internal Revenue Manual.

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allowed in a TEFRA proceeding. One commentator said that *Munro* had far-reaching negative ramifications, conceivably requiring partnership losses and credits be disregarded entirely at the partner level.[21]

However, not all of the reaction was negative. An early IRS Tax Litigation Bulletin called the case a "'significant victory' enabling the Service to assert adjustments to nonpartnership items where the taxpayer is oversheltered."[22] One commentator said that *Munro* "represents a reasonable interpretation of an otherwise difficult statute of limitations question."[23]

Other commentators proposed several solutions to address the *Munro* problem. The Los Angeles County Bar Association suggested legislatively subsuming the fact pattern of *Munro* under the definition of affected items.[24] Richard Cohen and Stephen Millman proposed giving the Tax Court the power to issue declaratory judgments,[25] and John Pennell came up with seven different proposals, including extending the partner's statute of limitations (and possibly also limiting the statute for partnership items).[26]

IRS and Congressional Response

The government's response to *Munro* was twofold. First, the IRS adopted the use of a *Munro* stipulation, which was offered to partners at the conclusion of deficiency proceedings in Tax Court. It allowed partnership items to be treated as correctly reported to compute the partner's deficiency in Tax Court. It also gave the Service additional time to make computational adjustments after a partnership-level proceeding.

But the *Munro* stipulation did not work if the partner was oversheltered. In that case, the IRS had to abide by the *Munro* decision until Congress specifically overturned it in 1997 by enacting section 6234.[27] That statute enabled the Service to issue a notice of adjustment to an oversheltered partner, even though no deficiency would result from the adjustment.[28] This allowed the IRS to avoid having the statute of limitations expire on the partner's tax return if the partnership proceeding was attenuated. Section 6234 also empowered the Tax Court to make declaratory judgments regarding the correctness of this adjustment but not regarding partnership and affected items.[29] No tax would be due on the Tax Court's determination but it would be treated as a final decision.

In cases not involving oversheltered returns, *Munro* may still apply (assuming no *Munro* stipulation has been obtained by the IRS). As Boris I. Bittker and Lawrence Lokken point out that it:

> is not clear whether the Tax Court will accept its decision as having been overruled in situations not addressed by the statute: partners reporting net income rather than net loss from partnership items or partners reporting net loss from partnership items but nevertheless having positive taxable income.[30]

***Munro* Stipulation's Failure to Extend Statute**

The *Munro* stipulation is an effective tool that allows both the IRS and partners to resolve a partner-level proceeding while awaiting the outcome of a slower partnership proceeding. If there is no lapse in the statute of limitations for partnership items, the Service can rely on the *Munro* stipulation to make computational adjustments to the partner's return once the partnership proceeding concludes.

However, the language of the stipulation exposes the Service to a serious statute of limitations problem in some circumstances. After all, by its terms, the *Munro* stipulation extends the statute for computational adjustments but not for partnership items.

The template text of the stipulation is as follows:

> It is hereby stipulated:
>
> 1. Petitioner(s) reported certain items on the [year] income tax return related to the investment in [partnership name].

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[21] Steven R. Mather, "Audit Procedures for Pass-Through Entities," 624-2nd BNA Tax Management IX.C.2.a. (2009).

[22] TLB 3069 (1989).

[23] John W. Schmehl, "Partnership Items Are Ignored in Determining a Deficiency for Nonpartnership Items," *J. Tax'n*, 388 (Dec. 1989).

[24] "Los Angeles County Bar Comments on Treasury Report on TEFRA Partnership Audit Procedures" (Sept. 17, 1990). An "affected item" is "any item to the extent it is affected by a partnership item." Section 6231(a)(5). TEFRA allows the IRS up to one year after the conclusion of a TEFRA partnership proceeding to assess any affected items. Section 6229(a) and (d)(2).

[25] Richard Cohen and Stephen Millman, "Handling Nonpartnership Tax Deficiencies When Partners Have Partnership Losses," 6 *J. Partnership Taxation* 211 (1989). Cohen and Millman proposed an "assessment" that fulfills the section 6501 requirement of being made within the limitations period, but for which tax will not be collected. *Id.* at 220-221.

[26] Pennell, *supra* note 16.

[27] JCT staff, "General Explanation of Tax Legislation Enacted in 1997" (1997), at 369-370 (explaining that the legislation overrules *Munro* and allows "the IRS to return to its prior practice of computing deficiencies by assuming that all [partnership and affected] items whose treatment has not been finally determined had been correctly reported on the taxpayer's return").

[28] Section 6234(a).

[29] Section 6234(c).

[30] Boris I. Bittker and Lawrence Lokken, *Federal Taxation Income, Estates & Gifts*, para. 112.3.

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2. [Partnership name] is a partnership that is subject to the unified partnership audit and litigation procedures set forth in sections 6221 et seq. (TEFRA partnership procedures).

3. For purposes of computing the deficiency [or overpayment] in this case, petitioner's partnership items relating to [partnership name] have been treated as if they were correctly reported on petitioner's income tax returns for the [tax year(s)] and they have not been adjusted as part of this docketed proceeding.

4. The tax treatment of petitioner's partnership items relating to [partnership name] will be resolved in a separate partnership proceeding conducted in accordance with the TEFRA partnership procedures.

5. The adjustments necessary to apply the results of the TEFRA partnership proceeding described in subparagraph 4 to petitioner, shall be treated as computational adjustments under section 6231(a)(6) and assessed, credited, or refunded accordingly.

6. To the extent that the computation of petitioner's tax liability that properly reflects the tax treatment of the partnership items relating to [partnership name], as determined in the TEFRA partnership proceeding described in subparagraph 4, would also result in a change in petitioner's tax liability attributable to nonpartnership items, as previously determined in this docketed proceeding, such change may be treated as a computational adjustment under section 6231(a)(6) and assessed, credited, or refunded accordingly.

7. Petitioner waives any restrictions on assessment or overpayment imposed by section 6501, 6511, and 6512, regarding any assessment, credit, or refund described in subparagraph 6, provided the assessment, credit, or refund is made within the period provided for computational adjustments under section 6231(a)(6).[31]

This text seems to unequivocally extend the statute of limitations only for computational adjustments. Subparagraph 7, for example, refers to a waiver of any restriction on assessment or overpayment, but only regarding any assessment, credit, or refund described in subparagraph 6.[32] Subparagraph 6 specifically limits its application to computational adjustments that properly reflect the tax treatment of the partnership items.[33]

This does not seem to be a close call or an unfair parsing of the language. If no partnership items can be properly adjusted in the partnership-level proceeding, the text of the *Munro* stipulation seems plain. The IRS should evidently not have the ability to assess any computational adjustments to the partner's return if the partner or the TMP has not otherwise validly extended the statute for partnership items.

In our view, express language is needed to keep the statute open. Section 6229(b)(3) requires that any agreement to extend the statute of limitations "under section 6501(c)(4) shall apply with respect to the period described in subsection (a) only if the agreement expressly provides that such agreement applies to tax attributable to partnership items."[34] *Munro* stipulations do not comport with the requirement of section 6229(b)(3). Finally, the *Munro* stipulation's express provision for extension of the statute for computational adjustments, and the lack of a similar provision for partnership items, shows that the latter was not extended. This reading comports with the *expressio unius est exclusio alterius* canon of construction.[35]

Without a strained reading, it is hard to escape the conclusion that such a stipulation cannot extend the statute for partnership items.

IRS Can't Rely on TMP Proceeding

Although one might presume (as apparently the Service does) that the statute for partnership items *must* still be open *whenever* there is an ongoing partnership-level proceeding, in reality, this is a flawed assumption. Courts have held that a TMP's consent to extend the statute of limitations was invalid when the TMP was operating under a debilitating conflict of interest as a result of a government criminal investigation.[36]

Courts have also held that a TMP's consent to extend the statute was invalid because the TMP had dissolved.[37] Even something as common as conversion from a partnership to a single-member LLC may result in the legal dissolution of a TMP. The

[31]IRM Example 35.11.1-7, *Munro* Stipulation for Deficiency Cases.

[32]*Id.*

[33]*Id.*

[34]Section 6229(b)(3).

[35]*In re Celotex Corp.*, 487 F.3d 1320, 1334 (11th Cir. 2007) ("The doctrine of expressio unius est exclusio alterius instructs that when certain matters are mentioned in a contract, other similar matters not mentioned were intended to be excluded").

[36]*Transpac Drilling Venture 1983-63 v. United States*, 26 Cl. Ct. 1245, 1247 (1992).

[37]*Barbados #7 Ltd. v. Commissioner*, 92 T.C. 804 (1989).

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Service has recently recognized that this may endanger partnership-level litigation in certain cases.[38]

Moreover, if a TMP dissolves or is otherwise disqualified to act on behalf of the partnership, the mailing of the final partnership administrative adjustment may not toll the statute of limitations, even if the FPAA was issued in a timely manner. Section 6229(d) provides that it is the mailing of the FPAA to the TMP that tolls the statute during the pendency of the partnership-level proceeding. If there is no valid TMP designation, this tolling may not occur.[39] The Service's own litigation guidelines for TEFRA acknowledge that without an FPAA mailed to the TMP, the statute will not be tolled.[40]

Courts have upheld the Service's mailing of a generic notice to the TMP at the partnership's address when there was a secret designation of a TMP that the Service did not know about.[41] However, given that the plain language of section 6229(d) requires the Service to mail the FPAA to the TMP, a generic notice may not suffice when the Service has reason to know of the TMP's dissolution (for example, in the case of a TMP's conversion to a single-member LLC).

Importantly, statute of limitations issues must be raised only in a partnership-level proceeding.[42] Therefore, the Service may not find out about any defect in the TMP's consents until years after the *Munro* stipulation has been filed in the Tax Court. This temporal glitch is not mere speculation. In fact, the Service has been concerned about the potential failures of consents signed by the TMP. Increasingly, the Service has required individual partners to extend the statute for *partnership* items. This is significant because there is no ''partnership statute of limitations'' — either the TMP can extend every partner's section 6501 period for assessing partnership items or the partners can extend the statute for themselves by agreement.[43]

The Service's prior practice was to require individual partners to sign Forms 872-I in cases in which it was concerned about the validity of consents signed at the TMP level. The forms expressly extended the statute for partnership items. The Service has now gone as far as to incorporate this language into the general Form 872, and it no longer uses the Form 872-I.[44]

Despite increasing concerns over the validity of consents by TMPs, the IRS has not updated its *Munro* stipulation language to protect the statute when a TMP's consents turn out to be defective. It is possible the Service would argue that the general tenor of the *Munro* stipulation assumes that the statute for partnership items will remain open in the partnership-level proceeding. But, as we have noted, this is a flawed assumption.

Conclusion

The enactment of section 6234 and *Munro* stipulations have proven to be partially effective at alleviating many of the difficult timing mismatches underlying TEFRA. However, the plain language of the *Munro* stipulation reveals that timing mismatches remain lurking in the corners of TEFRA and may never entirely go away.

In trying to solve the *Munro* problem, the Service may have inadvertently created another via the *Munro* stipulation. Even when the IRS secures a partner's consent to extend a statute for partnership items, that consent will likely expire if the partner signs a *Munro* stipulation and the Tax Court petition is dismissed. In some cases, notwithstanding a *Munro* stipulation, nothing will keep the statute open for partnership items once the partner's Tax Court petition has been dismissed.[45]

The *Munro* stipulation is effective when there are no defects in the TMP's consent to extend the statute for partnership items. Unfortunately, there are myriad reasons why a TMP's consents may prove defective, which means the Service may need to rely on partner-level consents.

[38]IRS NSAR 20111701F (''If a limited liability company with multiple members that is treated as a partnership is converted to a single member limited liability company, the partnership is terminated. The designation of that entity as tax matters partner would arguably be terminated because the partnership would [no] longer exist even though the state law entity continues to exist'').

[39]*Midland Mortgage Co. v. United States*, 576 F. Supp. 101, 107 (W.D. Okla. 1983) (invalid notice does not toll statute of limitations; any proceeding based on such notice also fails to toll statute of limitations); *Greve v. Commissioner*, 42 B.T.A. 142, 144-145 (1940) (the Service failed to send notice in strict compliance with statute and failed to correct error, therefore subsequent petition did not toll the statute of limitations) (''It is not surprising to find that there are no statutory provisions saving the Commissioner from the running of the statute of limitations under such circumstances'').

[40]Litigation Guideline Memoranda (1991) (''Only the issuance of the FPAA to the tax matters partner will toll the statute of limitations'').

[41]*Chomp Associates v. Commissioner*, 91 T.C. 1069 (1988).

[42]*Chimblo v. Commissioner*, 177 F.3d 119, 125 (2d Cir. 1999) (''Allowing individual taxpayers to raise a statute of limitations defense in multiple partner-level proceedings would undermine TEFRA's dual goals of centralizing the treatment of partnership items and ensuring the equal treatment of partners'').

[43]Section 6229(b)(1)(A) and (B).

[44]*See, e.g.*, 2010 IRS NTPCCA 201032039.

[45]Section 6503(a)(1) (extending statute of limitations on assessment during pendency of Tax Court petition and for 60 days after decision becomes final).

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The timing mismatch between partner-level and partnership-level proceedings creates serious problems for the IRS when there is a defect. The Service has failed to fully address this timing mismatch with the *Munro* stipulation, which is especially surprising given that it includes language expressly extending the statute of limitations for partnership items in its standard Form 872.

The *Munro* decision was a wake-up call to the IRS and the tax community to address the TEFRA timing problem. The statute of limitations issue may prove to be a land mine buried in the *Munro* stipulation. The Service should consider revising the *Munro* stipulation language to extend the statute for partnership items while the partner and the IRS await the outcome of the partnership-level proceeding.

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