# M&A, Partnerships and Procedure

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What's a partnership tax topic doing in the M&A Tax Report? Ever since the repeal of the *General Utilities* doctrine, M&A practice has not been the same. Gone are the days when it was just regular old corporate sales and reorganizations, dividends, spin-offs and split-ups.

The new rapid-growth (and maybe steroid-using) kid on the block was the flow-through entity. Add to that the labyrinthine check-the-box overlay, and you have a village. Foreign and domestic planning has evolved into a high-stakes, pick-your-poison debate. Corporate tax planners for a generation were used to dealing with a single level of tax on most business transactions. Along with a whole cadre of new people who don't remember the good old days, they had to confront the end of an era.

This was a time that gave way to a new dawn of flow-through entities. Partnership tax advisors became as much in demand as corporate ones. In short, this is not your father's M&A practice. And partnership tax issues led to constant push-back from the IRS.

### The 1980s

In 1982, Congress enacted rules designed to simplify audits involving large partnerships. The main feature of these rules is to create a partnership proceeding where partnership items can be adjudicated, rather than having multiple and separate proceedings with each partner.

This sounds simple. So did Internal Revenue Code Section ("Code Sec.") 338. Yet despite simplification efforts, fundamental complexities remain. Timing mismatches persist because partnership and nonpartnership items cannot be considered in the same proceeding. Partnership-level cases generally proceed slower than partner-level cases.

In the early years, it was not clear how partnership items could be taken into account when computing a partner's tax deficiency, or *vice versa*. Prior to 1989, the IRS generally computed deficiencies for individual partners by assuming that all partnership items were correctly reported. If a taxpayer was "oversheltered" (losses from partnership items offset any proposed adjustment to nonpartnership items), the IRS issued a notice of deficiency disallowing such partnership items for computational purposes only.

In 1989, this practice changed following the Tax Court's decision in *J. Munro*, 92 TC 71, Dec. 45,441 (1989). It required the IRS to stop disallowing partnership items in the case of oversheltered partner returns.

### *Munro* Doctrine

In *Munro*, the taxpayers had a net loss from partnership items even after accounting for nonpartnership income. They were oversheltered. The IRS increased nonpartnership income, but not enough to completely offset the reported net loss. The IRS then issued a statutory notice of deficiency by disallowing the partnership losses.

The taxpayers in *Munro* challenged the deficiency by claiming that the IRS had improperly considered adjustments to partnership income before the partnership audits had concluded. 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 nonpartnership items. The Tax Court rejected the IRS's arguments. In determining whether a deficiency at the partner level exists, the court ruled, the IRS cannot take into account partnership items that are subject to a separate and ongoing partnership proceeding.

### IRS Response

The IRS response to *Munro* was to use a "Munro Stipulation." The Munro Stipulation 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 IRS additional time to make computational adjustments after a partnership-level proceeding. But the Munro Stipulation did not work if the partner was oversheltered. There, the IRS had to live with *Munro* until Congress specifically overturned it in 1997.

### Congress Acts

Next, Congress enacted Code Sec. 6234. It enables the IRS to issue a notice of adjustment to an oversheltered partner, even though no deficiency would result from the adjustment. This allows the IRS to avoid having the statute of limitations expire on the partner's tax return if the partnership proceeding was attenuated. Code Sec. 6234 also empowers the Tax Court to make declaratory judgments as to the correctness of this adjustment, but not to partnership and affected items. No tax is due on the Tax Court's determination, but it is a final decision.

### Statute for Partnership Items

The Munro Stipulation is effective in allowing both the IRS and partners to resolve a partner-level proceeding while awaiting the outcome of a slower partnership proceeding. However, the language of the stipulation can expose the IRS to a statute of limitations problem in certain circumstances. By its terms, the Munro Stipulation extends the statute for computational adjustments, but not for partnership items.

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.

Code Sec. 6229(b)(3) seems pretty clear that any agreement to extend the statute of limitations for partnership items must be expressly stated. Munro Stipulations do not comport with this requirement. Of course, the Munro Stipulation expressly provides for extension of the statute for computational adjustments. Yet there is no similar provision for partnership items. Does that suggest the latter is not extended? It would seem so.

## For Whom the Statute Tolls

The IRS seems to assume that the statute for partnership items *must* still be open *whenever* there is an ongoing partnership-level proceeding. But this is a flawed assumption. Courts have held a TMP's consent to extend was invalid in some cases. For example, what if a TMP was operating under a debilitating conflict of interest as a result of a government criminal investigation? There may be a number of partnership cases where the IRS could be facing a nasty surprise.

A TMP's consent to extend the statute can also be invalid where the TMP had dissolved. Even something as common as conversion from a partnership to a single-member LLC may result in the legal dissolution of a TMP. The IRS has recently recognized that this may endanger partnership-level litigation in certain cases.

Moreover, if a TMP dissolves or is otherwise disqualified to act on behalf of the partnership, the statute may never be tolled. In order to make sure the statute of limitations does not expire, the IRS needs to mail a crucial notice to the TMP. If there is no TMP, how can the IRS do that? It's not always clear.

In some cases, courts have allowed the IRS to mail a "generic notice" to the TMP at the partnership's address. But this leniency is usually allowed where there was a secret designation of a TMP which the IRS did not know about. The law, however, appears to require that the IRS actually mail the notice to the TMP. If the IRS has reason to know that the TMP has dissolved, or worse, has a conflict of interest as a result of a criminal investigation, a generic notice may not suffice.

The government may argue that even if there is a problem with a TMP, the fact that a partnership proceeding has been filed should be enough to toll the statute. This line of argument might work in some cases, but not so well in others.

Courts have found that simply placing a case on the docket is usually enough to toll a statute, even if the party that files the case is not the right taxpayer, or there is a defect in the notice. However, this only is the case where the statute is still open when the petition is filed. If the IRS has delayed too long, then even a defective petition probably won't save the statute.

In *R.J. Strong, Jr.,* 62 TCM 1081, Dec. 47,705(M), TC Memo. 1991-531, the court noted that a defective petition can toll the statute of limitations. However, the court also observed that such a petition does not toll the statute if the statute had already expired by the time the petition—defective or not—was filed. The court stated, "Thus, there was no possible way that the period of limitations for assessment could have been suspended by the filing of a Tax Court petition."

Also, if the IRS knew there was a problem with its prior notices, or the consents to extend the statute it obtained, and chose to ignore the problem rather than fix it, then courts will probably find that the petition does not toll the statute. In *W.M. Greve,* 42 BTA 142, Dec. 11,224 (1940), the Board of Tax Appeals found that a petition filed after an invalid notice did not suspend the statute of limitations. The Court noted that the error was the IRS's own fault. Plus, the IRS had multiple opportunities to correct the error. Instead, the IRS chose to simply rely on what had been done.

Contrast that with the Ninth Circuit's decision in *J.M. O'Neill*, CA-9, 95-1 USTC ¶50,039, 44 F3d 803 (1995). Here, the TMP declared bankruptcy only a few months before the IRS notice was issued. Indeed, his bankruptcy was "unbeknownst to the Tax Court or counsel on either side." What if the parties had known of the bankruptcy? What if the IRS had known of it before it issued the notice? The decision in *Greve* suggests that the petition may not have tolled the statute in such a case.

Importantly, statute of limitations issues must only be raised in a partnership-level proceeding. Therefore, the IRS may not find out about any defect in the TMP's consents until years after the Munro Stipulation has been filed in Tax Court.

This is surprising, as the IRS has been concerned about the potential failures of consents signed by a TMP. Increasingly, the IRS has required individual partners to extend the statute for partnership items. In the past, the IRS only required select partners to extend the statute for partnership items when it was concerned about the validity of the TMP's consents. The IRS now incorporated this language into its general form for extending the statute of limitations, so it's not reserved only for special cases.

Nevertheless, the IRS has not updated its Munro Stipulation language to protect the statute where the TMP's consents turn out to be defective. This is a ticking time bomb waiting to go off when the IRS least expects it.

## M&A

Partnership tax planning is part of M&A practice today and likely will remain so. Inevitably, some of that will be procedure. Timing mismatches between partner-level and partnership-level proceedings create problems for taxpayers and the IRS.

In particular, the duration and complexity of partnership proceedings may create risks for M&A advisors trying to conduct due diligence. The *Munro* problem calls for careful planning. It was a wake-up call to the IRS and the tax community, but the IRS and Congressional reaction hasn't solved all the issues. Be careful out there.

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