The Importance of Lingering TEFRA Partnership Procedures:

Exploring Who Can File Court Petitions and the Consequences for Mistakes

By Hale E. Sheppard[*]

Hale E. Sheppard analyzes the transition from TEFRA rules to the new procedures surrounding partnership audits and warns that both old TEFRA procedures and the new centralized audit rules will be relevant for a few more years.

I. Introduction

Taxpayers have been struggling for decades to understand the complex partnership procedures introduced by the Tax Equity and Fiscal Responsibility Act ("TEFRA") back in 1982. Things are changing now as a result of the new centralized audit rules, which apply to partnership years starting in 2018. Many will be looking to the future, of course, but it is critical not to prematurely dispense with the past TEFRA rules because they will continue to govern partnership tax disputes concerning 2017 and earlier years. Given that the IRS generally has three years from the time a Form 1065 (*U.S. Return of Partnership Income*) is filed to complete an audit, and given that taxpayers in many audits voluntarily grant the IRS extensions of the assessment period, taxpayers will be contending with TEFRA issues for several years to come.

One issue will be what happens if the wrong person files a Petition with the Tax Court (or other proper federal court) to challenge proposed tax increases and penalties by the IRS. Under the TEFRA rules, the person essentially running the show for the partnership is the tax matters partner ("TMP"). Serious problems arise when a person professing to be the TMP is not. This happens in various ways,

HALE E. SHEPPARD, Esq., (B.S., M.A., J.D., LL.M., LL.M.T.), is a Shareholder in the Tax Controversy Section of Chamberlain Hrdlicka, Chair of the International Tax Group, and Member of the Executive Committee.

including when the TMP is not properly designated on the initial Form 1065, the TMP is acceptable at the outset but letter becomes ineligible, the TMP fails to correctly appoint a successor TMP upon departure, or the TMP lacks an ownership interest in the partnership and thus is not a partner. This article focuses on the last of these scenarios, exploring several cases, including a recent one from October 2017, in which the supposed TMP believed, erroneously, that he was empowered to bring an action before the Tax Court on behalf of the partnership.

II. Summary of Relevant Rules

In order to appreciate the problems caused by actions taken by an improper TMP on behalf of a partnership, one must first understand the applicable rules, which remain in effect for all TEFRA partnership disputes through 2017.

A. Overview of Applicable Tax Law and Regulations

The TMP is the general partner designated by the partnership as its TMP, in accordance with the regulations.[1] If no general partner has been properly designated as the TMP, or if a designation has been terminated without first properly identifying a successor TMP, then the general partner with the largest profits interest in the partnership at the end of the relevant taxable year fills this role. This is based on the year-end data reported on Schedules K-1 to the Form 1065. If no one general partner has a bigger interest than the others, then the general partner whose name would appear first in an alphabetical listing prevails.[2]

For purposes of applying the preceding TMP-designation rules to a limited liability company ("LLC") instead of a partnership, only a "member-manager" is treated as a "general partner."[3] A member is a person who owns an interest in the LLC.[4] For its part, a member-manager of an LLC means any member who, either alone or together with others, has exclusive authority to make the management decisions necessary to conduct the business for which the LLC was formed.[5] State LLC provisions generally permit the LLC to select management by all members or by one or more managers, regardless of whether such managers are members of the LLC, and this can trigger the problems addressed in the four cases analyzed later in this article.[6]

B. Designating the TMP in Practice

One must consider how the TMP designation works in practice. This normally occurs by identifying the initial TMP in the organizational documents (*e.g.*, articles of limited partnership, partnership agreement, articles of formation, operating agreement, *etc.*) and then notifying the IRS by identifying the TMP on page 3 to Form 1065, where it says the following: "Designation of Tax Matters Partner (see instructions). Enter below the general partner or member-manager designated as the tax matters partner (TMP) for the tax year of this return." Page 3 to Form 1065 goes on to demand the name, identifying number, address, phone number, and, if the TMP is an entity, the name of the representative of such entity. The Instructions to Form 1065 expand on this guidance, as follows:

> Designation of Tax Matters Partner (TMP). If the partnership is subject to the rules for consolidated audit proceedings in Sections 6221 through 6234, the partnership can designate a partner as the TMP for the tax year for which the return is filed by completing the Designation of Tax Matters Partner section on page 3 of Form 1065. *The designated TMP must be (or have been) a general partner during the tax year* and, in most cases, also must be a U.S. person. For details, see Regulations section 301.6231(a)(7)-1. *For a limited liability company (LLC), only a member manager of the LLC is treated as a general partner*. A member manager is any owner of an interest in the LLC who, alone or together with others, has the continuing exclusive authority to make the management decisions necessary to conduct the business for which the LLC was formed. If there are no elected or designated member managers, [then] each owner is treated as a member manager. For details, see Regulations section 301.6231(a)(7)-2.[7]

C. The Need to Get It Right

The TMP possesses significant power over a partnership, with its ability to extend the assessment period during an audit by executing Form 872-P (*Consent to Extend the Time to Assess Tax Attributable to Items of a Partnership*), to bind the partnership to a settlement with the IRS, *etc.* A broad discussion about the authority and obligations of a TMP far exceeds the scope of this article. Suffice it to understand three things for our purposes. First, if a person who was not properly designated as a TMP files a Petition with the Tax Court defending the partnership against proposed tax increases and penalties, the IRS will file a Motion to Dismiss for Lack of Jurisdiction, attempting to permanently deprive the partnership (and thus its partners) of the chance to challenge the IRS. Second, the Tax Court may resolve a dispute only if it has jurisdiction,

and this issue can be raised at any time, even *after* the case has been litigated and the attorneys have filed their legal briefs.[8] Third, even if the IRS and the taxpayer are in agreement about the identity of the TMP, this does not necessarily mean that the Tax Court has jurisdiction over a case because jurisdiction cannot be conferred through harmony among the litigants.[9]

III. Analysis of the Relevant Cases

In the world of tax disputes, procedure is king. If one does not possess a deep understanding of administrative and judicial rules, deadlines can be missed, opportunities can be squandered, and the chance to have one's day in court can be lost. The cases examined below demonstrate potential consequences of having a non-TMP attempt to represent a TEFRA partnership before the Tax Court.

A. *Sente Investment Club Partnership of Utah*

The taxpayer in *Sente* was a general partnership whose partnership agreement designated Zell Mills as the "managing partner."[10] In this capacity, Mr. Mills kept the books and records, signed and filed Forms 1065 with the IRS, sent Schedules K-1 to the partners, signed checks on the partnership's account, and made investment decisions for the partnership. Mr. Mills received a salary for providing these management services. However, as the Tax Court noted, "Mills did not at any time during 1983 or 1984 own a capital or profits interest in Sente, and he was never shown as a partner on a Sente [Schedule] K-1."

The IRS sent an audit-selection notice for the partnership to Mr. Mills, who, consistent with the obligations of a TMP, sent the IRS data about the partners (*i.e.*, their names, addresses, taxpayer identification numbers, and size of ownership interests) and notified all the partners about the start of the audit. At the end of the audit, the IRS, after applying the general-partner-owning-the-largest-profits-interest-at-the-end-of-the-year rule, sent a notice of final partnership administrative adjustment ("FPAA") to Otis Vienna, as the TMP. Mr. Vienna then forwarded the FPAA to Mr. Mills, who filed a timely petition with the Tax Court.

The IRS filed a Motion to Dismiss for Lack of Jurisdiction based on three arguments: (i) Mr. Mills was not a partner within the meaning of Code Sec. 6231(a)(2); (ii) even if Mr. Mills were a partner, he was never properly designated as the TMP; and (iii) Mr. Mills was not the TMP under the general-partner-owning-the-largest-profits-interest-at-the-end-of-the-year rule since he was not a general partner and he had no profits interest.

The Tax Court offered the following analysis. The Tax Court agreed that Mr. Mills, who was never a partner in the partnership, could not serve as TMP: "Mills, not being a partner, was not and could not be designated as the tax matters partner. Rather, the record reflects that the partners chose Mills to perform the duties of managing the partnership for a salary." The Tax Court went on to note that (i) the IRS was authorized to issue the FPAA to Mr. Vienna pursuant to the general-partner-owning-the-largest-profits-interest-at-the-end-of-the-year rule; (ii) Mr. Vienna, as TMP, was the only person legally able to file a Petition within the first 90 days after issuance of the Petition; and (iii) the Petition, filed by Mr. Mills, was "defective because it was not signed by the TMP or legal counsel for the TMP."

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The Tax Court then focused on the real issue in the case; that is, whether the "defective" Petition would prove "fatal" to the partnership. The Tax Court indicated that, while it had addressed a similar issue *outside* the context of TEFRA, this was an issue of first impression when it came to TEFRA partnerships. The Tax Court stated the following in confirming the novelty of the issue: "We have not previously addressed this issue in the context of [an FPAA]."

The Tax Court showed clemency to the taxpayer in *Sente*, explaining that Mr. Vienna received the FPAA and forwarded it to Mr. Mills, such that he could file a Petition, and that Mr. Mills provided the Tax Court in the response to the Motion to Dismiss for Lack of Jurisdiction an affidavit confirming that he authorized Mr. Mills to act on his behalf. The Tax Court concluded that, the Petition filed by Mr. Mills, although "imperfect," was filed on behalf of Mr. Vienna, in his capacity as TMP. However, emphasized the Tax Court, the Petition was still problematic because Mr. Mills was not a person admitted to practice before the Tax Court. The Tax Court indicated that it would issue an Order allowing Mr. Vienna the chance to file a proper Amended Petition.

B. *Montana Sapphire Associates*

The taxpayer in *Montana Sapphire* was a limited partnership whose "managing general partner," as elected by the partners, was James McAuliffe, the accountant for the partnership.[11] The Tax Court pointed out that "[a]t no time, however, has McAuliffe owned a capital or profits interest in [the partnership]." The limited partnership agreement stated that the "managing general partner" would serve as the TMP. At the end of the audit, the IRS issued an FPAA, and Mr. McAuliffe filed a Petition with the Tax Court. The IRS then filed a Motion to Dismiss for Lack of Jurisdiction, primarily arguing that the Petition was invalid because it was not filed by the TMP, as required by the Internal Revenue Code and the applicable Tax Court rules.

The Tax Court divided its analysis into two parts, the first of which was whether the Petition filed by Mr. McAuliffe, the accountant with no ownership interest in the partnership, was invalid. After describing the tax provisions defining the terms "partner" and "TMP" for TEFRA purposes, the Tax Court stated the following: "Since McAuliffe was not and is not a partner in [the partnership], he cannot qualify under the statute as tax matters partner." The Tax Court then went on to hold the following:

> In holding that McAuliffe cannot qualify as tax matters partner under the statute, we reject [the] argument that [the IRS's] treatment of McAuliffe evidences that [the IRS] selected McAuliffe as tax matters partner under Section 6231(a)(7). McAuliffe could not be selected by [the IRS] as the tax matters partner of [the partnership] for the same reason that he could not qualify under Section 6231(a)(7)(A) or (B): he is not and never was a partner in the partnership … The Petition filed at the direction of McAuliffe within the 90-day period was not filed by the tax matters partner of [the partnership]. It was not signed by the tax matters partner of the partnership or counsel on behalf of the tax matters partner. The petition does not comply with Section 6226(a) or [Tax Court] Rule 240(c)(1). Accordingly, the petition is defective in this regard.

The Tax Court then turned its attention to the second issue, namely, whether the Petition must be permanently dismissed because it was defective. The Tax Court, referencing *Sente* and others, underscored the fact that it had granted taxpayers leave to file Amended Petitions in several cases where a timely yet defective Petition had been filed. The Tax Court then explained that (i) Mr. McAuliffe was acting as the agent of the partners, any one of whom could have qualified as TMP; (ii) the attorney who filed the Petition believed that he was doing so correctly based on representations by Mr. McAuliffe and the power granted to the "managing general partner" in the partnership agreement; and (iii) if the IRS got its way, the effect would be that the partners "would have no judicial remedy" with respect to the partnership adjustments listed in the FPAA. In light of this, the Tax Court held the Motion to Dismiss for Lack of Jurisdiction in abeyance for a period, such that the taxpayer could clarify for the Tax Court the identity of the TMP and for such TMP to file an Amended Petition.

C. *1983 Western Reserve Oil & Gas Co., Ltd.*

The taxpayers in *1983 Western Reserve* were two limited partnerships.[12] Trevor Phillips, a general partner, was designated as the TMP. Mr. Phillips later disappeared after a warrant for his arrest was issued when he failed to comply with a Summons issued by the IRS.

Creditors and limited partners started involuntary bankruptcy proceedings against the partnerships in District Court in California. Richard Shaffer was appointed receiver, and the related Order by the District Court stated that Mr. Shaffer could do the following: "act personally or through agents and counsel as tax matters partner under the [TEFRA rules] on behalf of the Western Reserve partnerships in all proceedings before the Internal Revenue Service or any other tax or administrative agency and to take such actions as the receiver may deem advisable." The Tax Court pointed out that "Shaffer was not, however, a general or limited partner" of the partnerships.

At the end of the tax audit, the IRS issued FPAAs to the partnerships. Mr. Shaffer, supposedly in his capacity as TMP, filed Petitions with the Tax Court. Identical Petitions were also filed by so-called five-percent groups, presumably as a precautionary measure. The IRS later filed Motions to Dismiss for Lack of Jurisdiction regarding the Petitions filed by Mr. Shaffer on grounds that he was not eligible to do so because he was not the TMP.

The Tax Court first pointed out that the Order issued by the District Court in connection with the bankruptcy of the partnerships only empowered Mr. Shaffer to perform duties as the TMP in proceedings before the IRS or other tax or administrative agency, and the Tax Court is a judicial body. Accordingly, concluded the Tax Court, the Order did not grant Mr. Shaffer the power to file Petitions in response to the FPAAs.

Next, after reviewing the TEFRA provisions defining "TMP," the Tax Court ruled against Mr. Shaffer and in favor of the IRS on the following grounds:

> The statutory provisions are clear and unambiguous: a tax matters partner designated by the partnership or identified pursuant to the largest-profits-interest rule must be a general partner in the partnership … . The legislative history is equally clear. Shaffer, the court-appointed receiver, is not, and never was, a partner in [the partnerships]. Thus, he could not qualify as the tax matters partner under Section 6231(a)(7)(A) or (B). Nor has the [IRS] purported to select Shaffer as tax matters partner. Although Shaffer could not qualify under the statute as tax matters partner since he never held an interest in the partnership, we note that our opinion in this case does not involve the issue of a court's power to appoint a nonpartner as tax matters partner for purposes of a partnership proceeding in this Court, a question we need not and do not decide. This Court does not have jurisdiction to consider a petition filed by a person or entity not qualified by law. Shaffer cannot qualify as the tax matters partner of the partnerships for purposes of filing a petition in this Court since (1) the District Court did not purport to empower him to file a petition with this [Tax] Court nor (2) does he otherwise meet the requirements of the statute. Accordingly, the petitions filed by Shaffer will be dismissed for lack of jurisdiction.

The harshness of the preceding opinion was significantly migrated by the fact that the dismissal of the Petitions filed by Mr. Shaffer did not deprive the partners of judicial review. Indeed, directly after rejecting Mr. Shaffer, the Tax Court clarified which of the Petitions later filed by various five-percent groups would advance toward litigation. In other words, because multiple Petitions were filed under multiple theories, the partnerships were able to have their issues addressed by the Tax Court anyway.

D. *Cambridge Partners, LP*

1. Claims for Refund by TEFRA Partnerships

Normally, taxpayers make a claim for refund by filing an amended tax return or a Form 843 (*Claim for Refund and Request for Abatement*). Things are different in the context of TEFRA partnerships. They generally file a Form 8082 (*Notice of Inconsistent Treatment or Administrative Adjustment Request*) ("AAR").[13] A partner may file an AAR for any partnership taxable year (i) within three years of the date on which the Form 1065 for the partnership was actually filed and (ii) before the IRS mails the TMP of the partnership an FPAA.[14] The AAR filed by a TMP may take one of two forms. It may request that the treatment shown on the AAR be substituted for the treatment of the partnership items on the Form 1065 to which the AAR relates ("Substitute AAR"). Alternatively, it may request non-substitute return treatment ("Claim for Refund AAR").[15] If any part of the Form 8082 filed by the TMP is not allowed by the IRS, then the TMP may file a Petition with the Tax Court or other appropriate federal court.[16]

2. Main Facts and Filings

The two partnerships at issue in *Cambridge Partners* were advertised as investment partnerships, which garnered about 230 total investors.[17] John Natale was the general partner and TMP for both partnerships, and his management triggered immediate and sustained losses. Instead of properly reporting such losses, Mr. Natale reported fake profits, thereby converting the partnerships into classic Ponzi schemes. Among the false documents prepared by Mr. Natale were the Schedules K-1 issued to the limited partners. These caused the partners to file Forms 1040 reporting and paying taxes on supposed income, when, in reality, they had suffered considerable losses.

The situation collapsed, as all Ponzi schemes eventually do, when Mr. Natale was unable to find sufficient new partners to make the capital contributions necessary to meet the redemption obligations to existing partners. Mr. Natale pleaded guilty to various felonies and went to jail. He also consented to a finding in a related civil case that he committed fraud. The civil consent judgement in March 2000 initially appointed James Zazzali as receiver for Mr. Natale and the partnerships; he was later replaced by Kenneth Nowak.

Mr. Nowak, in his capacity as receiver, filed on behalf of the partnerships amended Forms 1065 and AARs to reflect accurate financials for 1997, 1998, and 1999. While reviewing the AARs, the IRS attempted to find a limited partner willing to serve as TMP and thus ratify the previously filed AARs. None would do so. Therefore, the IRS eventually rejected the AARs on grounds that they were not signed by the TMP of the partnerships, as required. Consequently, Mr. Nowak, as receiver, filed a Petition with the Tax Court with respect to the AAR for 1997 in April 2003. In January 2004, the IRS filed a Motion to Dismiss for Lack of Jurisdiction. Within a month of the IRS's submission, the New Jersey Superior Court issued an Order stating the following:

> [T]he Receiver is, and has been, authorized to act as, and take all actions required of, the Tax Matters Partner, on behalf of the Cambridge Entities, including, but not limited to the filing of documents, returns,

> amended returns, K-1s, Administrative Adjustment Requests and *any and all other filings and petitions necessary or appropriate to carryout [sic] and fulfill the obligations of the Receiver, with and to the Internal Revenue Service, the United States Tax Court, any and all appeals, motions, or any related matter before or from the Internal Revenue Service and/or the United States Tax Court, including any other agency, court, or appellate tribunal* (this shall include, but not be limited to, the filing of Administrative Adjustment Requests with the Internal Revenue Service, and all actions in connection with any state and federal agencies, all administrative matters and proceedings, administrative agencies, administrative courts, tax courts, and/or appellate review), nunc pro tunc, as of the date of the Receiver's initial appointment.

The Tax Court held a hearing on the Motion to Dismiss for Lack of Jurisdiction for 1997 in February 2004 and took the matter under advisement. Three days later, Mr. Nowak filed separate Petitions related to the AARs for 1998 and 1999. In August 2004, the IRS filed Motions to Dismiss for Lack of Jurisdiction for those additional two years, too.

3. Analysis by the Tax Court

Tax Court explained that, on the day that a receiver was first appointed in March 2000, applicable law dictates that Mr. Natale ceased to be the TMP. It then recognized that the IRS can appoint a limited partner (instead of a general partner) as a TMP, but only in narrow circumstances. The Tax Court emphasized, citing *Montana Sapphire* and *Western Reserve*, that the relevant law "does not permit the designation of a nonpartner as TMP under any circumstances." The Tax Court went on to say that federal courts, not state courts, have the ability to appoint a TMP in certain cases based on "the extrastatutory notion that a court possesses certain inherent powers to protect parties to the litigation before it and to effectively manage its docket."

Getting down to business, the Tax Court indicated that its jurisdiction in *Cambridge Partners* was conditioned on (i) the disallowance by the IRS of an AAR filed by the TMP of the partnerships and (ii) the filing of a proper Petition with the Tax Court by the TMP. Thus, the key issue was whether Mr. Nowak was the TMP when he filed the AARs and Petitions.

The Tax Court stated, and Mr. Nowak did not dispute, that Code Sec. 6231(a)(7) does not permit a non-partner to serve as TMP, and Mr. Nowak was never a partner in the partnerships. Nevertheless, Mr. Nowak argues that the Tax Court still has jurisdiction because (i) it has inherent, non-statutory authority to appoint a non-partner, like Mr. Nowak, as TMP, and (ii) the New Jersey Superior Court has similar authority, which it used in issuing the Order in 2004 authorizing Mr. Nowak to serve as TMP.

The Tax Court rejected Mr. Nowak's first contention, about inherent authority, because it constituted putting the cart before the horse:

> We must have jurisdiction over a case in order to use our inherent power to appoint a TMP … . Stated another way, we cannot invoke our inherent power to appoint a TMP in order to bootstrap invoking our jurisdiction over these cases. To use our inherent power for that purpose would be to abolish by judicial fiat the jurisdictional limitations of Section 6228. Moreover, as discussed earlier, our inherent power to appoint a TMP and/or powers under Rule 250 do not permit us to give that TMP the powers that would be necessary to invoke our jurisdiction, namely the powers to file AARs and petition the Court.

The Tax Court, likewise, declined the second position raised by Mr. Nowak for two main reasons. First, the Tax Court did not take kindly to a state court essentially trying to trump federal tax law enacted by Congress. It levied the following criticism:

> Whether Mr. Nowak qualified as TMP of the partnerships when he filed the AARs and the Tax Court petitions *is unquestionably a matter of Federal tax law*. As such, that issue is not governed by a *State* court's orders and judgments … . Moreover, the [New Jersey] superior court purported to give Mr. Nowak the general powers of a TMP appointed under Section 6231(a)(7)-e.g., the power to file AARs and Tax Court petitions. Section 6231(a)(7) does not authorize any *State court* (or for that matter, any court) to do so; and any court's inherent authority to appoint a TMP, if it exists at all, should be narrowly delineated to harmonize with *Federal tax law* to the extent reasonably possible.

Second, immediately after it seemed to criticize the state court and reject Mr. Nowak, the Tax Court explained that it was not necessary to rule on the issue because it was moot.

> [W]e need not decide whether New Jersey courts have the inherent power to appoint a TMP because the New Jersey court that established the receivership and purported to authorize Mr. Nowak to act as TMP has at his request

terminated the receivership. *Consequently, there is no longer any party even purporting to act as TMP under statutory or inherent court power to pursue this litigation* . . . . Mr. Nowak now lacks the requisite authority to act as TMP on behalf of the partnerships regardless of whether he had that power when he filed the underlying AARs and petitions. As a consequence, no party properly before the Court continues to argue that we have jurisdiction over these cases.

The Tax Court granted the IRS's Motion to Dismiss for Lack of Jurisdiction, the effect of which was depriving the partnerships, and thus their partners, of their opportunity for judicial review of the IRS's decision to reject the AARs.[18]

IV. Conclusion

The new centralized partnership audit rules take effect in 2018, and people are focused on this change. This is logical and practical, but it can also be problematic if taxpayers and their advisors jettison the TEFRA rules too hastily, particularly those concerning who can act as the TMP before the Tax Court. The four cases analyzed in this article warn the tax community to straddle the line, keeping in mind both the old TEFRA procedures and the new centralized audit rules, at least for nine more years.

ENDNOTES

* Hale specializes in tax audits, tax appeals, and tax litigation. You can reach Hale by phone at (404) 658-5441 or by email at *hale.sheppard@chamberlainlaw.com*.

1 Code Sec. 6231(a)(7).

2 Code Sec. 6231(a)(7); Reg. §301.6231(a)(7)-1(m)(1); Reg. §301.6231(a)(7)-1(m)(2).

3 Reg. §301.6231(a)(7)-2(a).

4 Reg. §301.6231(a)(7)-2(b)(2).

5 Reg. §301.6231(a)(7)-2(b)(3).

6 Reg. §301.6231(a)(7)-2(b)(3).

7 Internal Revenue Service. Instructions to Form 1065 for 2016, at 24.

8 *U.R. Neely*, 115 TC 287, 290, Dec. 54,062 (2000).

9 *D.A. Naftel*, 85 TC 527, 530, Dec. 42,414 (1985).

10 *Sente Investment Club Partnership of Utah*, 55 TCM 1565, Dec. 44,980(M), TC Memo. 1988-376.

11 *Montana Sapphire Associates, Ltd.*, 95 TC 477, Dec. 46,958 (1990).

12 *1983 Western Reserve Oil & Gas Co., Ltd.*, 95 TC 51, Dec. 46,717 (1990).

13 Reg. §301.6227(c)-1(a).

14 Code Sec. 6227(a).

15 Code Sec. 6227(c).

16 Code Sec. 6228(a)(2)(A); Reg. §301.6227(c)-1(b).

17 *Cambridge Partners, Ltd.*, TC Memo. 2017-194.

18 Although the details are unclear from the record, the Tax Court Opinion indicated at least twice that the potential inequity and harshness to the partners was largely mitigated by the fact that the IRS, as part of its interactions with Mr. Nowak as receiver, allowed the limited partners to file Forms 1040X or AARs to rectify the erroneous partnership items (at 9–10 and footnote 13).