LEE MEYERCORD is a Partner in Holland & Knight's Dallas office. **JAMES DAWSON** is a Partner in Holland & Knight's West Palm Beach office.

The Knight Watch

The Next Wave of Partnership Litigation— APA Challenges to BBA Regulations

By Lee Meyercord and James Dawson

Taxpayers have been racking up recent wins in Administrative Procedures Act ("APA") challenges to Internal Revenue Service ("IRS") rules and regulations.[1] As a result, taxpayers and practitioners are reading the preambles to regulations carefully to determine whether public comments are adequately addressed or whether the regulation may be subject to an APA challenge.

The complex partnership audit rules enacted in the Bipartisan Budget Act of 2015 (the "Centralized Audit Rules" or "BBA") have given rise to a host of regulations to implement the procedurally complex regime, including several controversial rules that commenters argued were inconsistent with Congress' intent and general tax principles. The predecessor to the Centralized Audit Rules (the much-maligned Tax Equity and Fiscal Responsibility Act ("TEFRA") partnership audit regime) resulted in significant litigation regarding procedural aspects of the rules. The BBA regulations were proposed and finalized with the TEFRA litigation top of mind, with the intent to minimize the procedural litigation under the Centralized Audit regime.

While the BBA rules may reduce some of the TEFRA-era litigation, there is still likely to be significant litigation on the scope, validity, and application of the BBA regulations. In particular, given the rise of taxpayer successes in APA challenges and some of the aggressive positions taken in regulations, the Centralized Audit Rules will be subject to APA challenges.

One such regulation is the special statute of limitations rule in Reg. §301.6241-7(f), which allows the IRS to use the partner's statute of limitations if the partner controls the partnership or has extended its statute of limitations, and the extension also extends the time for assessing tax attributable to partnership-related items. This column addresses whether this end-run around the partnership-level statute of limitations could be subject to an APA challenge.

I. The Regulatory Statute of Limitations Extension

Code Sec. 6241(11)(A)[2] provides that "[i]n the case of partnership-related items which involve special enforcement matters," the Secretary may issue regulations providing that the Centralized Audit Rules do not apply to such items or that such items are subject to special rules. Code Sec. 6241(11)(B) lists particular areas that present special enforcement concerns, which include the failure to comply

 © 2023 CCH INCORPORATED AND ITS AFFILIATES. ALL RIGHTS RESERVED.

with the push-out rules, termination and jeopardy assessments, criminal investigations, indirect methods of proof, foreign partners or partnerships, and "other matters that the Secretary determines by regulation present special enforcement considerations."

Under this authority to adopt regulations to address special enforcement considerations, the IRS and Treasury issued Proposed Reg. §301.6241-7(f) allowing the IRS to make partnership adjustments after the partnership-level statute of limitations has expired if the partner's statute of limitations is open and either (1) the partner has control over the partnership (as determined under Code Secs. 267(b) and 707(b)); or (2) the partner has extended the partner's statute of limitations under Code Sec. 6501, and the extension expressly states that the partner is extending the time to adjust and assess any tax attributable to partnership-related items for the taxable year.[3] Presumably, the form for extending statutes of limitations will incorporate standard language that extends the statute of limitations for partnership-related items, making this exception likely to apply anytime a partner extends its statute of limitations.

Taxpayers may challenge an adjustment that is made after the partnership's statute of limitations as untimely because the regulation is invalid.

Wolters Kluwer®

The preamble contends that IRS resource issues in partner-level audits and tiered partnership structures present "special enforcement considerations" under Code Sec. 6241(11)(B)(vi) that justify the application of a partner-level statute of limitations for partnership adjustments in certain circumstances. The preamble to the proposed regulations justified this rule because "[t]he true tax impact and completeness of the partnership's reporting may not be apparent except by reviewing the partners' returns that report the partnership-related items … especially in situations where the partnership structure includes many related and controlled entities."[4] In these circumstances, "the most efficient way to examine the partnership's reporting might be as part of a consolidated examination or during the examination of the controlling individual. In these cases, all of the related and controlled entities and their transactions can be considered together, benefiting both the IRS and the taxpayer by eliminating the need for separate examinations."[5] However, as noted above, the rule is not limited to situations involving tiered partnerships or a controlling partner with multiple related entities, but applies whenever a partner has extended its statute of limitations (assuming the required language is included).

II. Lessons from TEFRA and Legislative History

To understand how the use of the partner's statute of limitations is contrary to legislative intent, it is important to understand how the statute of limitations worked under the prior partnership audit regime (TEFRA). TEFRA allows partnership adjustments if either the partnership or partner-level statute of limitations is open.[6] This rule was the subject of significant litigation.[7] Congress is presumed to be aware of this significant litigation when it enacted the BBA, which expressly provides that the statute of limitations for partnership adjustments is determined exclusively at the partnership level, and the partner's statute of limitations is not taken into account.[8]

Statutes of limitations are strictly construed in accordance with their terms.[9] For example, in *Brockamp*, the Supreme Court rejected an equitable exception to the statute of limitations for refund claims because the statute "sets forth its limitations in a highly detailed technical manner, that linguistically speaking, cannot easily be read as containing implicit exceptions."[10] Likewise, Code Sec. 6235 contains detailed limitations for the time period in which partnership adjustments may be made. Unlike TEFRA, the statutory language of Code Sec. 6235 nowhere suggests that the statute of limitations for partnership adjustments may be determined at the *partner* level.[11] Code Sec. 6235 sets forth explicit exceptions to its general time limits, and those specific exceptions do not include whether a controlling partner's statute of limitations is open or a partner has agreed to extend its statute of limitations.[12]

The legislative history of Code Sec. 6235 further confirms that Congress intended the statute of limitations for partnership adjustments to be determined exclusively at the partnership level.[13] When Congress revised certain provisions of the Centralized Audit Rules after their enactment, it addressed other statute of limitations issues, but it chose not to add a partner-level statute of

limitations.[14] As explained in comments on the proposed regulations, as part of the Tax Technical Corrections Act of 2018 ("TTCA"), Congress explicitly addressed special statutes of limitations for taxes imposed by a chapter other than Chapter 1 in the same Section of the Code that includes special enforcement provisions.[15] The TTCA also fixed a statute of limitations glitch that would have allowed the IRS to issue a Notice of Proposed Partnership Adjustments ("NOPPA") to revive an otherwise closed statute of limitations.[16] Despite Congress' focus on statute of limitations issues in the technical corrections, Congress declined to enact any provision to alter the rule in Code Sec. 6235 that the statute of limitations for partnership adjustments is determined exclusively at the partnership level. Thus, the statute and related legislative history do not suggest that control or a partner's agreement to extend its statute of limitations should result in a longer limitations period for partnership adjustments.

The Treasury Department and the IRS received comments from the State Bar of Texas Tax Section and the American Bar Association expressing these concerns that the IRS and Treasury's broad exception to the partnership statute of limitations was inconsistent with legislative intent and not narrowly tailored to the special enforcement considerations identified in the preamble.[17] The regulations were finalized in December 2022 without any substantive changes to Reg. §301.6241-7(f). The preamble to the final regulations does not offer a compelling or complete response to the comments.

III. Final Regulations

The preamble to the final regulations makes clear that the Treasury Department and IRS view Code Sec. 6241(11) as giving them unchecked authority to toggle off the BBA rules when they deem it appropriate, regardless of whether it is inconsistent with other provisions in the BBA or contrary to legislative intent. The preamble recognized that "the centralized partnership audit regime provides that adjustments are made at the partnership level based on the partnership's period of limitations" but argues that "Congress, by enacting Code Sec. 6241(11), contemplated that there would be times when the centralized partnership audit rules did not apply."[18] Therefore, "any special enforcement provision that adjusts partnership-related items outside of the centralized partnership audit regime or provides special rules governing the period of limitations on assessment when items are adjusted outside of the centralized partnership audit regime is not inconsistent with Congress' intent."[19]

In response to comments that the rule was not remotely tailored to the purported special enforcement consideration (tiered partnerships or controlling partners that own multiple related entities), the preamble vaguely states (without explanation) that "the special enforcement considerations provided in the preamble to the November 2020 Notice of Proposed Rulemaking (NPRM) may also apply in non-tiered structures." However, it is not at all clear what special enforcement consideration this is referring to, as the explanation in the preamble is focused on the complexity of tiered structures or controlling partners that own multiple related entities. If the "special enforcement concern" is that the IRS may discover a mistake or error on the partner's return after the partnership-level statute expires, that is true in a wide variety of circumstances and is the very nature of a statute of limitations. The IRS and Treasury should not be able to decide that possibility allows the IRS to use a different statute of limitations that may still be open to make adjustments. As courts have recognized, "[s]tatutes of limitation frequently involve some hardship, but the alleviation of that hardship is a matter of policy for the Congress."[20] In addition, the issues surrounding multi-tiered partnership structures were a significant impetus for enacting the Centralized Audit Rules, and Congress chose not to enact a partner-level statute of limitations despite its familiarity with the issues presented by such structures.[21]

The preamble also makes the unpersuasive argument that Reg. §301.6241-7(f) "does not extend the period of limitations" because it "merely changes what period of limitations applies." But the preamble simultaneously recognizes that the rule only applies if the partner's period of limitations is open, and the partnership-level statute of limitation is closed. Therefore, the impact of using the partner's statute of limitation is to extend the time to adjust and assess any tax attributable to partnership-related items.[22]

IV. APA Challenge

The preamble's failure to adequately address the comments makes Reg. §301.6241-7(f) subject to an APA challenge. The ability for taxpayers to successfully challenge regulations in this situation stems from the IRS' victory in *Mayo Foundation*. The IRS urged the Supreme Court in *Mayo Foundation* that treasury regulations should be entitled to the same *Chevron*

© 2023 CCH INCORPORATED AND ITS AFFILIATES. ALL RIGHTS RESERVED.

deference as other agency regulations.[23] The Supreme Court agreed with the IRS that the same deferential standard of review applicable to other agency rules should "apply with full force in the tax context."[24] Essential to the Supreme Court's decision was the fact that the regulation had been issued through the notice and comment process, which the Supreme Court found was "a very good indicator of delegation meriting *Chevron* treatment" and a "significant sign that a rule merits *Chevron* deference." Thus, the price of *Chevron* deference is that IRS and Treasury must comply with the APA.[25]

The most fundamental APA requirement is that an agency must engage in "reasoned decision making" and provide contemporaneous explanations of its reasoning.[26] A rule that is not the product of reasoned decision is arbitrary and capricious and violates 5 USC §706(2)(A). When reviewing the agency's explanation, the court "may not supply a reasoned basis for the agency's action" and "may not accept … counsel's post hoc rationalizations for agency actions."[27]

In addition, the agency must comply with the APA's three-step procedure for notice and public comments:

1. An agency must issue a general NPRM[28];
2. The agency must give "interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments,"[29] and the agency "must consider and respond to significant comments received during the period for public comment"[30]; and
3. In promulgating the final rule, the agency "must include in the rule's text 'a concise general statement of [its] basis and purpose.'"[31]

The basis and purpose statements must enable the court to see the objections and why the agency reacted to them as it did.[32] In the statement, the agency must rebut "vital relevant" or significant comments.[33]

In the special enforcement regulations, the IRS and Treasury Department failed to adequately respond to comments that the regulation was not tailored to the purported special enforcement considerations of tiered partnerships or controlling partners with multiple related entities. The IRS and Treasury's failure to respond to these comments leaves the regulation subject to a challenge that it violates the procedural requirements of the APA and is therefore arbitrary and capricious.

V. Conclusion

Taxpayers may challenge an adjustment that is made after the partnership's statute of limitations expires as untimely because the regulation is invalid. This could give rise to the very litigation that the Centralized Audit Rules were supposed to avoid. Given the complexity of the Centralized Audit Rules and the extensive and far-reaching regulations, and the bizarre implication of the various rules (*e.g.*, the wrong partners may bear the tax under the default rule), litigation on these rules will extend far beyond the special enforcement regulations.

Wolters Kluwer®

ENDNOTES

1 *See*, *e.g.*, *D.F. Hewitt*, CA-11, 2022-1 USTC ¶50,102, 21 F4th 1336 (2021); *Mann Construction*, CA-6, 2022-1 USTC ¶50,122, 27 F4th 1138 (2022); *Liberty Global*, No. 1:20-cv-03501, 2022 WL 1001568, DC-CO, 2022-1 USTC ¶50,134 (2022); *Green Valley Investors LLC*, 159 TC No. 5, Dec. 62,122 (2022).

2 All Section references are to the Internal Revenue Code of 1986, as amended.

3 Proposed Reg. §301.6241-7(f).

4 Preamble to Prop. Reg. §301.6241-7(f), 85 FR 74,948 (Nov. 24, 2020).

5 *Id*.

6 Code Sec. 6229 (repealed 2015). Code Sec. 6229(a) provided that the statute of limitations for adjustment of partnership items "shall not expire before" the date that is three years after the later of the date the partnership return was filed or the last day for filing such return. Courts concluded that the "shall not expire before" language made clear that Code Sec. 6229(a) was not an exclusive statute of limitations, and an assessment of tax attributable to a partnership item was timely as long as the period of limitations remained open under either Code Sec. 6501 (relating to a partner's statute of limitations) or Code Sec. 6229 (relating to a partnership's statute of limitations).

7 *See, e.g., Rhone-Poulenc Surfactants & Specialties, L.P.*, 114 TC 533, Dec. 53,929 (2000); *Curr-Spec Partners, L.P.*, CA-5, 2009-2 USTC ¶50,578, 579 F3d 391 (2009), *cert. den.*, SCt, 130 SCt 3321 (2010); *AD Global Fund, LLC*, CA-FC, 2007-1 USTC ¶50,312, 481 F3d 1351 (2007); *Andantech LLC*, CA-DC, 2003-1 USTC ¶50,530, 331 F3d 972 (2003); *Schumacher Trading Partners II*, FedCl, 2006-2 USTC ¶50,454, 72 FedCl 95 (2006); *Grapevine Imports, Ltd.*, FedCl, 2007-2 USTC ¶50,555, 71 FedCl 324 (2006); *Russian Recovery Fund, Ltd.*, FedCl, 2015-2 USTC ¶50,433, 101 FedCl 498 (2011).

8 Code Sec. 6235(a).

9 *E. Badaracco, Sr.*, SCt, 84-1 USTC ¶9150, 464 US 386, 398, 104 SCt 756 (1984) ("…even were we free to do so, there is no need to twist Code Sec. 6501(c)(1) beyond the contours of its plain and unambiguous language in order to comport with good policy….").

10 *M. Brockamp*, SCt, 97-1 USTC ¶50,216, 519 US 347, 350, 117 SCt 849 (1997).

11 *Lamie v. U.S. Trustee*, SCt, 540 US 526, 542, 124 SCt 1023 (2004) ("If Congress enacted into law something different from what it intended, then it should amend the statute to conform to its intent.").

12 *See* Code Sec. 6235(b) (extension by agreement) and Code Sec. 6235(c) (fraud).

[13] The legislative history summarizes the statute of limitations rules and never suggests an exception if the partner's statute of limitations is open or the partner agreed to an extension. Staff of the Joint Comm. On Tax'n, General Explanation of the Tax Legislation Enacted in 2015 (JCS-1-16), at 75–76 (2016). Instead, the legislative history makes clear that it is the *partnership* that "may consent to an extension of time within which a partnership adjustment may be made." *Id*. at 75. Further, the legislative history reiterates that under the Centralized Audit Rules, any partnership adjustments are "determined at the *partnership level*" and "[a]ny tax attributable to these items is assessed and generally is collected at the *partnership level*." *Id*. at 62 (emphasis added).

[14] Corrections were made to the Centralized Audit Rules by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, Div. Q, §411, 129 Stat. 2241 (2015), effective as if included in the BBA. Additional corrections and modifications were made by the TTCA included in the Consolidated Appropriations Act, 2018, Pub. L. No. 115-66, Div. U, Title II, 132 Stat. 348 (2018), effective as if included in the BBA.

[15] *See* Code Sec. 6241(9); Tex. State Bar Tax Section, "BBA Special Enforcement Comments" (Jan. 25, 2021); American Bar Assoc. Tax Section, BBA Special Enforcement Matters (Oct. 8, 2021), available at *www.americanbar*.

[16] Prior to the amendment by the TTCA, the time period when a NOPPA must be issued was not specified. The TTCA amended Code Sec. 6231(b)(1) to provide that any NOPPA must be issued within the three-year period in Code Sec. 6235(a)(1). TTCA, Pub. L. No. 115-66, Div. U, Title II, 132 Stat. 348 (2018). Therefore, the NOPPA must be issued within three years of the later of the date the partnership return was filed, the date the return was due, or the date the partnership filed an AAR. I.R.C. §6231(b)(1).

[17] Tex. State Bar Tax Section, "BBA Special Enforcement Comments" (Jan. 25, 2021); American Bar Assoc. Tax Section, BBA Special Enforcement Matters (Oct. 8, 2021), available at *www.americanbar.org/content/dam/aba/administrative/taxation/policy/2021/100821comments.pdf*.

[18] T.D. 9969 (Dec. 8, 2022).

[19] *Id*.

[20] *A. Kreiger*, CA-3, 76-2 ustc ¶9593, 539 F2d 317, 322 (1976); *see also Rothensies v. Electric Storage Battery Co*., SCt, 47-1 ustc ¶9106, 329 US 296, 301, 67 SCt 271 (1946) (citing *Chase Securities Corp. v. Donaldson*, 325 US 304, 314 (1937)) (Statutes of limitations "are by definition arbitrary, and their operation does not discriminate between the just and unjust claim, or the avoidable or unavoidable delay.").

[21] Staff of the Joint Comm. On Tax'n, Description of Certain Revenue Provisioins Contained in the President's Fiscal Year 2016 Budget Proposal (JCS-2-15), at 264–266 (2015) (Explaining that the Centralized Audit Rules are intended to address several of the difficulties under TEFRA including those that arise "in the case of tiered partnerships or partnerships with other types of passthrough partners.").

[22] T.D. 9969 (Dec. 8, 2022).

[23] SCt, 562 US 44, 131 SCt 704 (2011). Mayo urged the court to apply the multi-factor test in *National Muffler Dealers Assn., Inc.*, SCt, 79-1 ustc ¶9264, 440 US 472, 99 SCt 1304 (1979). Under *Chevron's* two-part framework, the court first considers whether Congress has "directly spoken to the precise question at issue." SCt, 467 US 837, 842-43, 104 SCt 2778 (1984). If so, that is the end of the inquiry. However, "if the statute is silent or ambiguous on a specific issue" then the Court goes on to step two to consider "whether the agency's answer is based on a permissible construction of the statute." The days of *Chevron* deference may be numbered, as the Supreme Court will decide its fate in *Loper Bright Enterprises v. Raimondo,* No. 22-451.

[24] 562 US at 55.

[25] *Id*. at 55–57.

[26] *Judulang v. Holder*, SCt, 565 US 42, 52-53, 132 SCt 476 (2011); *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, SCt, 463 US 29, 43, 103 SCt 2856 (1983).

[27] *Motor Vehicle Mfrs. Ass'n*, 463 US at 50.

[28] 5 USC §553(b).

[29] 5 USC §553(c).

[30] *Perez v. Mortg. Bankers Ass'n*, SCt, 575 US 92, 96, 135 SCt 1199 (2015).

[31] 5 USC §553(c).

[32] *Encino Motorcars, LLC v. Navarro*, SCt, 579 US 211, 221, 136 SCt 2117 (2016); *Lloyd Noland Hosp. & Clinic v. Heckler*, CA-11, 762 F2d 1561, 1565 (1985).

[33] *Grand Canyon Air Tour Coalition v. FAA*, DC-DC, 154 F3d 455, 468 (1998); *Hussion v. Madigan*, CA-11, 950 F2d 1546, 1554 (1992).

Wolters Kluwer

This article is reprinted with the publisher's permission from Taxes The Tax Magazine®, a monthly journal published by CCH Incorporated. Copying or distribution without the publisher's permission is prohibited. To subscribe to Taxes The Tax Magazine® or other journals, please call 1-800-344-3734. All views expressed in this publication are those of the author and not necessarily those of the publisher or any other person.

 © 2023 CCH INCORPORATED AND ITS AFFILIATES. ALL RIGHTS RESERVED.