

Office of Chief Counsel
Internal Revenue Service
Memorandum

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Via Electronic Mail

Date: August 25, 2014

To: Veera Jain
Revenue Agent, Employment Tax

Thru: Mae F. Butler
Revenue Agent Team Manager

From: Area Counsel (Dallas)
(Tax Exempt/Government Entities)

Subject: **Application of TEFRA to Employment Tax Examinations**

Taxpayer: EIN:
Period(s):

SUMMARY

We conclude that that the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), as codified in I.R.C. § 6221, et seq., does not apply to employment tax examinations or worker classification proceedings for entities that are otherwise subject to TEFRA for income tax purposes. For that reason, there are no special procedures that revenue agents must follow when conducting employment tax examinations of TEFRA partnerships.

INTRODUCTION

By memorandum dated September 10, 2013, you requested our guidance upon the following three issues, as applied to your employment tax examination of

:

1) Whether there are special procedures that revenue agents must follow when conducting examinations of entities subject to TEFRA for income tax purposes?

2) [REDACTED]

3) [REDACTED]

Since your examination of [REDACTED] is ongoing, we will address only the first question in this memorandum.

FACTS

We based the following summary upon information and documents provided by Revenue Agent Veera Jain. If you believe that we have misstated any facts, please let us know, since our conclusions may change as a result.

[REDACTED] is a [REDACTED] limited liability company organized on [REDACTED]. At all relevant times, it has been treated as a partnership for income tax purposes. On [REDACTED], [REDACTED] filed its [REDACTED] Form 1065. The Form 1065 included Schedules K-1, Partner's Share of Income, Deductions, Credits, etc., for [REDACTED] different members. The members included managing members [REDACTED] and [REDACTED]. [REDACTED] was classified as a subchapter S corporation for tax year [REDACTED]. Additionally, it owned just under a [REDACTED] % interest in profits, losses, and capital at all times in [REDACTED]. The majority of partners had a [REDACTED] % interest in profits, losses, and capital at the end of tax year [REDACTED].

The examination of [REDACTED]

LAW & ANALYSIS

If the Commissioner determines that a taxpayer owes a deficiency in taxes imposed by Subtitle A, Subtitle B, Chapter 41, Chapter 42, Chapter 43, or Chapter 44 of the Internal Revenue Code (the Code), the Commissioner may send a notice of the deficiency to the taxpayer. I.R.C. § 6212(a). In response, the taxpayer may petition the United States Tax Court for a pre-assessment review of the deficiency determination. I.R.C. § 6213(a).

An entity that is classified as a partnership for Federal income tax purposes

usually owes no income tax¹. I.R.C. § 701. The partnership is nevertheless still responsible for reporting its income. I.R.C. § 6031. In turn, each partner is liable for income tax on the partner's distributive share of various items of income and loss from the partnership. I.R.C. §§ 701, 702(a), (c). An income tax examination of a partnership will not usually result in the partnership owing a deficiency. I.R.C. §§ 701, 6211. However, examination adjustments to a partnership's income or losses could result in a partner owing a deficiency based upon the partner's distributive share of the adjustments and the other items on the partner's income tax return. See I.R.C. §§ 701, 702, and 6211.

Historically, income tax examinations of partnerships involved a series of separate-but-related audits for each partner. See I.R.M. 4.31.1.4(1) (06-05-2013). To the extent that these audits resulted in multiple notices of deficiency, each deficiency determination would have to be defended in a separate court proceeding. See Id. This approach resulted in duplicative audits and litigation. Bausch & Laumb, Inc. v. Commissioner, T.C. Memo. 2009-112, slip op. at *6 (May 21, 2009). Congress enacted the unified partnership audit and litigation provisions of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 402 (TEFRA partnership procedures or "TEFRA") in order to relieve the associated burden, as well as to provide for consistent treatment of partnership income, gain, loss, deductions, and credits by all partners in a partnership. Samueli v. Commissioner, 132 T.C. 336, 340 (2009).

In general, TEFRA applies to any partnership required to file a partnership return under I.R.C. § 6031(a). See I.R.C. § 6231(a)(1)(A). However, an exception exists for any small partnership, which is any partnership with ten or fewer members, all of which are individuals (other than a non-resident alien), subchapter C corporations, or estates of deceased partners. I.R.C. § 6231(a)(1)(B)(i).

TEFRA divides all items of income, deduction, credit, and expense into partnership and nonpartnership items. I.R.C. § 6231(a)(3) and (4). A partnership item is any item that the partnership must take into account for income tax purposes to the extent the Secretary determines that such item is more appropriately determined at the partnership level than at the partner level. I.R.C. § 6231(a)(3). A nonpartnership item is any item that is not a partnership item. I.R.C. § 6231(a)(4). Under TEFRA, all partnership items, the proper allocation of those items among partners, and the applicability of any penalty, addition to tax, or additional amount relating to an adjustment to a partnership item are determined at the partnership level. I.R.C. § 6221.

Under section 7436 of the Code, if, in connection with the audit of any person, there is an actual controversy involving a determination by the Secretary as part of an examination that (1) one or more persons performing services for such person are employees of such person for purposes of subtitle C; or, (2) such person is not entitled to treatment under subsection (a) of section 530 of the Revenue Act of 1978 with

¹ A notable exception to this rule is foreign withholding tax. I.R.C. §§ 1441-1446.

respect to such an individual, then the Tax Court may determine the correctness of the Secretary's determination and of the amount of employment tax owed following the filing of an appropriate pleading. I.R.C. § 7436(a). Such proceedings incorporate many procedures that apply to deficiency cases. Specifically, the principles of I.R.C. §§ 6213(a)-(d), (f), 6214(a), 6215, 6503(a), 6512, and 7481 apply in the same manner as if the Secretary's determination were a Notice of Deficiency. I.R.C. § 7436(d). Within those incorporated sections, the only references to TEFRA relate to suspending the statute of limitations and to the overpayments relating to partnership items. See I.R.C. §§ 6503(a), 6512(a)(4), (b)(3) (flush language). Additionally, the TEFRA statutes make no reference to I.R.C. § 7436 or to Subtitle C of the Code (Employment Taxes and Collection of Income Tax).

The employment tax liabilities that might arise under audit are not subject to direct determination under the TEFRA procedures. Under I.R.C. §§ 6221 and 6231(a)(3), the TEFRA partnership procedures are limited to "partnership items," which are items under Subtitle A of the Code. Employment taxes are imposed under Subtitle C. Furthermore, in Chef's Choice v. Commissioner, 95 T.C. 388 (1990), the Tax Court explained that the intent of the TEFRA provisions was merely to aggregate the partners' income tax deficiency proceedings into a single proceeding insofar as their income tax liability derived from a partnership. Since the partnership does not pay income tax, it is not even a party to the TEFRA proceeding relating to income tax determinations. Id. at 394–395. Finally, an employment tax liability under Chapters 21–25 does not meet the I.R.C. § 6211(a) definition of a "deficiency" to which the TEFRA restriction on assessment under I.R.C. § 6225 could apply. Thus, no notice of final partnership administrative adjustment would be required under I.R.C. § 6225 in order to make an employment tax assessment.

Based upon the foregoing analysis, TEFRA procedures do not apply to employment tax examinations or worker classification proceedings for persons that are otherwise subject to the TEFRA partnership procedures for income tax purposes. For that reason, you do not have to follow those procedures when conducting the employment tax examination of .

CONCLUSION

Based upon the information presented, we conclude that is subject to TEFRA for income tax purposes, but that the TEFRA procedures do not apply to employment tax examinations or to worker classification proceedings.

Please note that

. If in the course of the audit this issue arises, the Service should seek advice from counsel.

If you have any questions concerning this matter, please contact Attorney Peter T. McCary at (904) 665-1902.

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