Bedrosian v. Commissioner, 143 T. C. No. 4 (2014)

The U. S. Tax Court held that the TEFRA partnership audit procedures applied to the Bedrosians' tax case despite IRS errors, affirming the IRS's determination that the partnership was subject to TEFRA. The court rejected the taxpayers' arguments under sections 6223(e) and 6231(g)(2), ruling that they did not convert partnership items to nonpartnership items and that the IRS's determination to apply TEFRA was reasonable. This decision underscores the complexities of TEFRA and the strict adherence required to its procedures, significantly impacting how partnerships and their items are audited and litigated.

Parties

John C. Bedrosian and Judith D. Bedrosian (Petitioners) v. Commissioner of Internal Revenue (Respondent). The Bedrosians were the petitioners at the trial and appeal levels. The Commissioner of Internal Revenue was the respondent throughout the litigation.

Facts

John and Judith Bedrosian engaged in a Son-of-BOSS transaction through Stone Canyon Partners, a partnership subject to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) procedures due to the presence of pass-through entities as partners. The Bedrosians claimed significant losses on their 1999 tax return stemming from this transaction. The IRS initiated an audit focusing on the Bedrosians' individual income tax returns rather than a TEFRA partnership audit, leading to confusion over the applicable procedures.

The IRS eventually issued a Notice of Final Partnership Administrative Adjustment (FPAA) for Stone Canyon Partners, which was not timely challenged by the Bedrosians. Subsequently, the IRS issued a Notice of Deficiency (NOD) to the Bedrosians, which included the same adjustments as the FPAA and additional ones. The Bedrosians timely petitioned the Tax Court regarding the NOD but failed to timely challenge the FPAA, resulting in the dismissal of their petition against the FPAA for being untimely.

Procedural History

The IRS issued an FPAA to Stone Canyon Partners, followed by an NOD to the Bedrosians. The Bedrosians filed an untimely petition against the FPAA, which was dismissed by the Tax Court and upheld by the Court of Appeals for the Ninth Circuit. They timely petitioned the Tax Court regarding the NOD, which led to the current case. The Tax Court previously dismissed adjustments related to 1999 as partnership items but retained jurisdiction over nonpartnership items for 2000. The Court of Appeals dismissed an appeal from the Tax Court's partial dismissal due to lack of a final judgment. The Bedrosians then filed a motion for summary judgment

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in the Tax Court, seeking jurisdiction over all items in the NOD.

Issue(s)

Whether the partnership items in the NOD converted to nonpartnership items under section 6223(e)(2) or (e)(3)?

Whether the IRS reasonably determined under section 6231(g)(2) that TEFRA did not apply to Stone Canyon Partners?

Rule(s) of Law

Under section 6223(e)(2), partnership items convert to nonpartnership items if the TEFRA proceeding has concluded when the IRS mails the notice. Under section 6223(e)(3), a partner may elect to have partnership items treated as nonpartnership items if the TEFRA proceeding is ongoing at the time of mailing, but such an election must be made within 45 days and filed with the IRS office that mailed the notice. Section 6231(g)(2) provides that TEFRA does not apply to a partnership if the IRS reasonably but erroneously determines, based on the partnership's return, that TEFRA does not apply.

Holding

The Tax Court held that the partnership items did not convert to nonpartnership items under section 6223(e)(2) because the TEFRA proceeding was ongoing at the time the FPAA was mailed. The court also held that no valid election was made under section 6223(e)(3) as the petition filed by the Bedrosians did not constitute substantial compliance with the election requirements. Finally, the court found that the IRS did not make a reasonable determination under section 6231(g)(2) that TEFRA did not apply to Stone Canyon Partners, as the partnership's return indicated the presence of pass-through partners, precluding the small partnership exception.

Reasoning

The court reasoned that for section 6223(e)(2) to apply, the TEFRA proceeding must have concluded, which was not the case when the FPAA was mailed. Under section 6223(e)(3), the Bedrosians did not make a timely election nor did their petition substantially comply with the election requirements due to lack of intent and procedural deficiencies. Regarding section 6231(g)(2), the court determined that the IRS's decision to apply TEFRA was based on the partnership's return, which clearly indicated the presence of pass-through partners, making the application of TEFRA reasonable and necessary. The court rejected the argument that the IRS initially treated the audit as non-TEFRA, emphasizing that the FPAA was the definitive determination of TEFRA applicability. The court also noted that the IRS's conduct during the audit did not constitute a determination that TEFRA did not apply, and any such determination would have been unreasonable given the partnership's return.

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Disposition

The Tax Court denied the Bedrosians' motion for summary judgment, affirming that it lacked jurisdiction over the partnership items in the NOD due to the ongoing TEFRA proceedings and the lack of a valid election or reasonable determination under the relevant sections of the Code.

Significance/Impact

This case highlights the complexity and strict procedural requirements of TEFRA, emphasizing the importance of timely and proper elections and the IRS's reliance on partnership returns to determine the applicability of TEFRA. It underscores the challenges taxpayers face in navigating these procedures and the potential for significant tax implications based on procedural determinations. The decision reinforces the need for clear and consistent IRS actions in audits and the critical nature of timely responses by taxpayers to IRS notices to preserve their rights to judicial review.

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