A Worthy Holding that the IRS Cannot Ignore Its Own Rules for BBA Elections

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. The author of this column is Richard M. Lipton, Senior Counsel, Baker McKenzie, Dallas, Texas, richard.lipton@bakermckenzie.com. Readers are invited to write to the editors: Leah Gruen, Counsel, Baker & McKenzie, Chicago, Illinois, leah.gruen@bakermckenzie.com and Samuel P. Grilli, Partner, Baker & McKenzie, Chicago, Illinois, samuel.grilli@bakermckenzie.com.

A recent Tax Court decision, *SN Worthington Holdings LLC*,[1] provides a worthy reminder that the IRS must follow its own rules, even if it does not like the result in a particular situation. In this case, the IRS was required to accept a partnership's representation that it had assets sufficient to pay a potential tax liability, even though the IRS doubted that the representation was correct, because the IRS' own regulations required no more than a representation to that effect.

The partnership at issue (SNW) filed a tax return for 2016, which was before the January 1, 2018, effective date of the partnership audit and litigation procedures enacted by the Bipartisan Budget Act of 2015 (BBA). Although the BBA rules were not yet effective in 2016, the IRS issued regulations allowing partnerships to "elect in" to the BBA procedures for the period after enactment but before mandatory application. The regulations permitting such an election required, however, that the electing partnership make a representation that it has sufficient assets to pay the amount that would be due (the imputed underpayment) in the event that the IRS prevailed in the dispute.

In this case, SNW made an election to apply the BBA rules to an ongoing audit of its 2016 tax year and also represented that it had sufficient assets to pay any resulting tax liability if the IRS' position were upheld. SNW made the representation, but the IRS did not believe it was valid. Specifically, after receiving the election on a Form 7036, Election under Section 1101(g)(4) of the BBA, the IRS sent a letter stating:

> As part of the election, you represented that the partnership has sufficient assets, and reasonably anticipates having sufficient assets, to pay the potential imputed underpayment that may be determined during the partnership examination. After reviewing the tax return it appears that you do not meet the requirements.

The letter went on to state that if SNW disagreed with this determination, it could provide supporting documents within 30 days to show that it had sufficient assets. SNW did not respond. Consequently, the IRS then sent a letter to SNW notifying it that the IRS had determined that the election into the BBA procedures was invalid because proof of sufficient assets was not provided.

As a result, the IRS insisted that the prior regime, the TEFRA audit procedures, should apply, and the IRS issued a Notice of Final Partnership Administrative Adjustment (FPAA) to SNW for the tax return filed in 2016. SNW filed a petition with the Tax Court and then moved to have the case dismissed for lack of jurisdiction on the grounds that the FPAA was invalid due to the election to apply the BBA rules to the year in issue.

BACKGROUND ON PARTNERSHIP AUDIT PROCEDURES

In 1982, Congress enacted TEFRA, which significantly changed the procedures by which the IRS determined deficiencies relating to certain partnerships. Before TEFRA, the IRS made adjustments to partnership items at the partner level. TEFRA established unified audit and litigation procedures through which the IRS could make adjustments at the partnership level. Specifically, section 6221 (TEFRA) provided that "the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level." Even though TEFRA adjustments were determined at the partnership level, the assessment and collection of tax attributable to such adjustments remained at the partner level.[2]

The BBA, which replaced the TEFRA procedures, streamlined the partnership audit process by allowing audits, adjustments, and payments to all occur at the partnership level.[3] Although enacted in 2015, the BBA procedures included a delayed effective date, generally applying to partnership returns for tax years beginning after December 31, 2017.[4] Thus, under the default rules, any return with a tax year beginning before January 1, 2018, remained subject to TEFRA.

EARLY ELECTION INTO THE BBA PROCEDURES

Although enacted with a delayed effective date, the BBA allowed partnerships to elect into the BBA procedures for partnership tax years beginning after November 2, 2015 and before January 1, 2018.[5] Specifically, section 1101(g)(4) of the BBA gave partnerships the right to elect, in the form and manner prescribed by the Secretary, into the BBA procedures for years beginning after the BBA's enactment and before 2018.

The Secretary promulgated Treasury Regulation § 301.9100-22, setting forth the form and manner for making such an election. As provided in paragraph (a) of such section:

> Pursuant to section 1101(g)(4) of the Bipartisan Budget Act of 2015, Public Law 114-74 (BBA), a partnership may elect at the time and in such form and manner as described in this section for amendments made by section 1101 of the BBA... to apply to

> any return of the partnership filed for an eligible taxable year as defined in paragraph (d) of this section. An election is valid only if made in accordance with this section. Once made, an election may only be revoked with the consent of the Internal Revenue Service (IRS). An election is not valid if it frustrates the purposes of section 1101 of the BBA. A partnership may not request an extension of time under § 301.9100-3 for an election described in this section.

To make a valid election into the BBA procedures, a partnership must provide a written statement that satisfies the requirements of Treasury Regulation § 301.9100-22(b)(2). Among other things, that regulation requires a partnership to make a series of representations, including, as relevant here, that: "The partnership has sufficient assets, and reasonably anticipates having sufficient assets, to pay a potential imputed underpayment with respect to the partnership taxable year that may be determined under subchapter C of chapter 63 of the Internal Revenue Code as amended by the BBA."[6]

EARLY ELECTION OF SNW

In the case of SNW, the parties disagreed as to whether the partnership satisfied the requirement of Treasury Regulation § 301.9100-22(b)(2)(ii)(E)(*4*). The core of the dispute centered on what is required to make an early election. SNW argued that it was sufficient to make the representation that SNW had enough assets to pay a potential imputed underpayment. As a result, SNW argued that its election was valid because the election complied with the plain text of the regulation. Specifically, the election complied with the time, form, and manner requirements prescribed in the Treasury regulation. According to the taxpayer, the IRS did not have the authority to request additional information from SNW that was not stated in or required by the regulation and, therefore, SNW's failure to provide the additional information did not make the election invalid. Alternatively, SNW argued that its election was valid because, even if the IRS had the authority to request additional information, the information already provided to the IRS established that SNW had enough assets to pay the potential imputed underpayment. Thus, the denial of SNW's election was unreasonable, arbitrary, and capricious.

The IRS disagreed, arguing that SNW failed to make a valid election into the BBA procedures for 2016. Specifically, the IRS contended that SNW was required to provide additional requested information showing that it had, and would continue to have, enough assets to pay a potential imputed underpayment. In substance, the IRS argued that to make a valid election into the BBA procedures, a partnership must establish (and not merely represent) that it has sufficient assets to satisfy an imputed underpayment. The IRS cited the regulatory language of Treasury Regulation § 301.9100-22(a) and the preamble to Temporary Treasury Regulation § 301.9100-22T[7] as support for its argument that SNW had to prove that it had sufficient assets. According to the IRS, allowing an election into the BBA procedures when a partnership fails to establish that fact would frustrate the purpose of the BBA procedures. The IRS argued that it could deny the election for that reason. Alternatively, the IRS argued that SNW should be equitably estopped from arguing that it made a valid election into the BBA procedures "based on its misleading silence and later statements regarding the applicability of TEFRA, to which respondent relied upon to his detriment."

TAX COURT'S DECISION

The court observed that taxpayers make valid elections when they comply with the plain text of the election requirements. The manner for making an election can be set forth in various ways, including by statute or Treasury regulation. But, according to the court, once such manner is established, the IRS may not add ad hoc additional requirements.[8] In other words, when determining whether an election is valid, the IRS may not require the taxpayer to satisfy more stringent requirements than the provision authorizing the election.[9]

The Court concluded that SNW's election satisfied the requirement that it represent that it had sufficient assets to satisfy an imputed underpayment. SNW timely submitted a signed Form 7036, which included the following text: "This partnership ... [h]as sufficient assets, and reasonably anticipates having sufficient assets, to pay the potential imputed underpayment that may be determined during the partnership examination." The form and the wording were designed by the IRS. By submitting a document with this specific text, SNW complied with the plain text of Treasury Regulation § 301.9100-22(b)(2)(ii)(E)(*4*).

The court disagreed with the IRS that SNW had to prove that it had, and would continue to have, enough assets to pay a potential imputed underpayment, as such requirement was not included in the regulatory language. The court emphasized that when there is doubt as to the meaning of a regulation, a court will interpret the regulation against the drafter.[10] When a court interprets regulations, it presumes "the drafter of the regulation. . . said what it means and means what it said."[11] And when interpreting a transitional provision with limited applicability, as was the case here, the court construes the provision liberally.[12] In the case of Treasury Regulation § 301.9100-22, the IRS could have required partnerships to *establish* that they have enough assets to pay an imputed underpayment. Instead, the IRS required partnerships to *represent* that they have enough assets to pay an imputed underpayment, which is what SNW did.[13] There is a critical distinction between these two requirements.

Further, the court found that the BBA procedures themselves refuted the IRS' contention that it would frustrate "the purposes of section 1101 of the BBA for a partnership to elect early into BBA when it does not have sufficient assets to pay an imputed underpayment that may become due," given the BBA procedures contemplate such a situation and set forth mechanics for addressing that possibility. Under the BBA procedures, if a partnership does not promptly pay an imputed underpayment, the IRS can assess and collect from the partners of the partnership their proportionate shares of the imputed underpayment.[14]

A WORTHY TAKEAWAY

SN Worthington is another worthy judicial decision which reinforces the

constraints on the IRS' ability to take positions inconsistent with the literal language of regulations that the IRS issued. Your editors observe that this decision reinvigorates a worthy construct of tax law interpretation, as articulated by the Supreme Court a century ago, that: "[I]n statutes levying taxes the literal meaning of the words employed is most important[,] for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer."[15]

As the court in *SN Worthington* appropriately noted, the IRS could have required "proof" of sufficient assets when it adopted these regulations, but it chose not to do so. In accordance with rule of law principles, the IRS should not be permitted, in hindsight, to say that the regulations should be interpreted "as if" they contain provisions with additional requirements that simply are not there. The power to wield the regulatory pen carries with it the charge of having to live with the language that is written. The court delivers a worthy example of this fundamental principle in *SN Worthington.*

End Notes

1 162 T.C. No. 10 (2024).

2 *See* sections 6221, 6230(a)(2), 6231(a)(6) (TEFRA).

3 Section 6221(a) (BBA).

4 *See* BBA § 1101(g)(1), 129 Stat, at 638.

5 *See* BBA § 1101(g)(4), 129 Stat, at 638.

6 Treasury Regulation § 301.9100-22(b)(2)(ii)(E)(*4*).

7 *See* T.D. 9780, 2016-38 I.R.B. 357, 358 ("An election is also not valid if it frustrates the purposes of section 1101 of the BBA, which include the collection of any imputed underpayment that may be due by the partnership under section 6225(a) as amended by the BBA.").

8 *Roy H. Park Broadcasting, Inc. v. Commissioner*, 78 T.C. 1093, 1131-36 (1982).

9 *See Estate of McAlpine v. Commissioner*, 96 T.C. 134, 142-43 (1991), *aff'd*, 968 F.2D 459 (5th Cir. 1992).

10 *See United States v. Merriam*, 263 U.S. 179, 187-88 (1923) ("[I]n statutes levying taxes the literal meaning of the words employed is most important[,] for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer.").

11 *Sklar, Greenstein & Scheer, P.C. v. Commissioner*, 113 T.C. 135, 143 (1999).

12 *See Younger*, 64 T.C.M. (CCH) at 92-93.

13 *See Mississippi ex rei. Hood v. AU Optronics Corp.*, 571 U.S. 161, 169 (2014) (stating that if the drafter of a law intended a specific meaning, "it easily could have drafted language to the effect"). The court also considered and rejected the IRS' argument that the taxpayer was equitably estopped from contending that it had made a valid election; this issue is beyond the scope of this discussion.

14 Section 6232(f)(1)(B) (BBA).

15 *United States v. Merriam*, 263 U.S. 179, 187-88 (1923).