

# TAX PROCEDURE: THE NINTH CIRCUIT CONFIRMS THAT A DISREGARDED ENTITY IS A PASS-THRU PARTNER UNDER TEFRA

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The Tax Equity and Fiscal Responsibility Act (TEFRA) was enacted in 1982 to govern partnership audits. Despite its age, TEFRA still generates novel issues for courts. On June 7th, the Ninth Circuit affirmed the dismissal of a Tax Court petition brought by a taxpayer who owned his partnership interest through a limited liability company that was disregarded for tax purposes, ruling that form controls over substance, at least in this narrow context. [Seaview Trading LLC v. Comm'r](#), No. 15-71330, 2017 U.S. App. LEXIS 10109 (9th Cir. June 7, 2017).

Robert Kotick and his father formed Seaview Trading, LLC, a Delaware limited liability company that was taxable as a partnership. 2017 U.S. App. LEXIS 10109 at \*3. The Koticks owned Seaview through two other limited liability companies, AGK Investments LLC, which Kotick owned, and KMC Investments LLC, which was owned by his father. *Id.*

Seaview invested in a common trust fund, which thereafter generated a loss that Kotick reported on his 2001 return. *Id.* The IRS audited Kotick's 2001 return, making a variety of adjustments, but it did not disallow the loss. *Id.* at \*4. The IRS then audited Seaview; the audit began in 2005 and was completed in October 2010. The IRS proceeded under TEFRA, issuing a Final Partnership Administrative Adjustment that disallowed Seaview's loss from the trust investment and imposed penalties. *Id.*

Kotick sought to challenge the IRS determination. As TEFRA does not apply to small partnerships with ten or fewer partners, I.R.C. § 6231(a)(1)(B)(i), Kotick filed a petition with the Tax Court to challenge the audit adjustments, arguing that TEFRA was not applicable.

In response, the IRS filed a motion to dismiss for lack of jurisdiction, arguing that Seaview did not fall within the small partnership exception. It also argued that Kotick lacked standing to file a petition because he was not Seaview's tax matters partner and therefore could not file a petition within 90 days of the audit determination. See I.R.C. § 6646(a) (tax matters partner has authority to file a petition within 90 days of

audit determination), (b) (other partners may only file a petition if the tax matters partner fails to act). The Tax Court granted the motion to dismiss.

On appeal, the Ninth Circuit initially focused on the small partnership exception, which exempts partnerships from TEFRA's procedures if the partnership has "10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner." I.R.C. § 6231(a)(1)(B)(i). The court observed that a regulation put a restrictive reading on the small partnership exception, making it inapplicable if any partner in the partnership was a "pass-thru partner" under section 6231(a)(9) of the Code in the relevant tax year. *Seaview Trading*, 2017 U.S. App. LEXIS 10109 at \*6 (quoting Treas. Reg. § 301.6231(a)(1)-1(a)(2)). TEFRA defines a "pass-thru partner" as "a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership with respect to which proceedings under this subchapter are conducted." I.R.C. § 6231(a)(9).

While Kotick argued that a limited liability company that was a disregarded entity could not be a pass-thru partner, the Ninth Circuit rejected that view, electing to follow a prior revenue ruling, which the court found persuasive. *Seaview Trading*, 2017 U.S. App. LEXIS 10109 at \*7-\*11 (citing Rev. Ruling 2004-88, 2004-2 C.B. 165). In the court's view, the Revenue Ruling's conclusion that a disregarded entity was a pass-thru partner was entitled to *Skidmore* deference. The Court of Appeals observed that the definition of "pass-thru partner" plainly contemplated that it could apply to an array of ownership arrangements since the definition included a "similar person through whom other persons hold an interest in the partnership." *Id.* at \*9 (quoting I.R.C. § 6231(a)(9) and Rev. Ruling 2004-88). While Kotick argued that the Revenue Ruling had improperly given state law classification a dispositive role in determining federal tax consequences, the Ninth Circuit was not persuaded. In the court's view, the question presented was "whether an LLC's federal classification for federal tax purposes negates the factual circumstance in which the owner of a partnership holds title through a separate entity." *Id.* at \*10. State law was simply relevant to the question whether an entity held legal title to a partnership interest. *Id.* at \*11.

The Ninth Circuit also observed that Revenue Ruling 2004-88 was consistent with a prior Chief Counsel Advice memorandum that had read the definition of pass-thru partner to make TEFRA applicable "whenever indirect partners exist whose identity will not be reflected on the face of the partnership return." *Id.* (quoting IRS CCA 200250022, 2002 IRS CCA LEXIS 120 (Aug. 30, 2002)).

Next, the Court of Appeals turned to the question whether Kotick had standing to file a petition in his own name. In light of its holding that Kotick's interest in *Seaview* was held through a pass-thru partner, the court had little difficulty in affirming the Tax Court's order granting the motion to dismiss. AGK, the entity through which Kotick owned his interest in *Seaview*, was the general partner with the largest ownership interest, making it the tax matters partner under section 6231(a)(7)(B) of the Code. *Id.* at \*15-\*16. That gave AGK the exclusive right to file a petition within 90 days of the audit determination. Moreover, AGK had itself filed a petition with the Tax Court, rendering Kotick's petition superfluous.

The Ninth Circuit's determination that a limited liability company is a pass-thru partner, even if it is treated as a disregarded entity for tax purposes may appear unduly technical, but it promotes certainty by adopting a bright-line rule that the IRS can readily administer. The Tax Court had previously reached the same conclusion in *Bedrosian v. Commissioner*, 143 T.C. 83 (2014). Presumably, that was why Kotick's counsel filed a separate petition on behalf of AGK as well.



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