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U.S. Tax Court Issues Opinion in *Tigers Eye* Regarding *Golsen* Rule and TEFRA Proceedings

We rarely send out Legal Alerts about the so-called “TEFRA” rules that govern partnership audits and litigation because so few people would read them. In *Tigers Eye*, however, the Tax Court took a noteworthy step around the *Golsen* rule which requires the Tax Court to follow the precedent in the circuit to which the case is appealable. This is something to bear in mind in deciding whether to litigate in the Tax Court. Moreover, the case involves issues that the Tax Court obviously feels quite strongly about, as the decision is 211 pages long with many concurrences and dissents, and was decided by a majority vote of 8 to 5 with two of the majority votes concurring in result only.

Sutherland Observation: The Tax Equity and Fiscal Responsibility Act (TEFRA) rules are an extraordinarily complex set of procedural rules applicable to many partnership audits and litigation. The rules are full of pitfalls for both the Internal Revenue Service (IRS) and taxpayers, and they can often require multiple proceedings. *Tigers Eye* is just one of several recent decisions in which the Tax Court has shown its frustration with these rules. The substantive result of the *Tigers Eye* holding may be that many items previously thought to be partner-level issues will now be controlled in partnership-level proceedings, instead of the partner-level proceedings commenced after the partnership case is over. If so, then this may make it necessary for partners to participate in partnership-level cases because items previously thought to be partner-level issues will now effectively be *res judicata* if, or when, a partner-level proceeding is commenced.

Tigers Eye Holding and Summary

On February 13, 2012, the U.S. Tax Court held in *Tigers Eye Trading, LLC, et al. v. Commissioner*, 138 T.C. No. 6, 2012 WL 445944 (Feb. 13, 2012) (*Tigers Eye*), that (1) the Tax Court was not required to follow the applicable precedent of the appellate court for which *Tigers Eye* was appealable, (2) outside basis can be a “partnership item” and (3) outside basis and penalties applicable thereto can be determined in a partnership-level proceeding. (Outside basis is the basis for income tax purposes in a partner’s partnership interest and is relevant, for example, in determining the gain or loss resulting from a sale of the partnership interest.)

Tigers Eye is a partnership-level case under TEFRA. The IRS and the tax matters partner entered a stipulated decision in the case on December 1, 2009. That stipulated decision included an adjustment of outside basis to zero and an assertion of a 40% gross valuation misstatement penalty. Shortly after the stipulated decision was entered, the U.S. Court of Appeals for the D.C. Circuit held in *Petaluma FX Partners, LLC et al. v. Comm’r*, 591 F.3d 649 (D.C. Cir. 2010) (*Petaluma II*), that outside basis and penalties applicable thereto are affected items and not within a court’s jurisdiction in a partnership-level proceeding.¹ In response to *Petaluma II*, the participating partner in *Tigers Eye* moved to revise the

¹ Generally speaking, a court’s jurisdiction in a partnership-level proceeding under TEFRA is limited to determining “partnership items” and penalties related to partnership items. The term “partnership item” means “any item [(1)] required to be taken into account for the partnership’s taxable year under any provision of subtitle A [and (2) for which] . . . regulations prescribed by the Secretary provide that . . . such item is more appropriately determined at the partnership level than at the partner level.” I.R.C. § 6231(a)(3). The term “affected item” means “any item to the extent such item is affected by a partnership item.” I.R.C. § 6231(a)(5). Affected items that require partner-level determinations must be made in a notice deficiency after the close of the partnership-level proceeding. I.R.C. § 6230(a)(2).

stipulated decision to remove the adjustments to outside basis and related penalties, since the case would be appealable to the D.C. Circuit.

The Tax Court held in *Tigers Eye* that it was not bound by the D.C. Circuit decision in *Petaluma II*, and under applicable regulations outside basis is actually a partnership item determinable in a partnership-level proceeding when (1) the partnership is disregarded or (2) a partnership interest is obtained: (a) through contributions to the partnership or (b) from a transferor partner if a Section 754 election is in effect. While it is not completely clear, the majority opinion in *Tigers Eye* suggests that outside basis is almost always a partnership item, except when a partner obtains his partnership interest from a transferor partner and a Section 754 election is not in effect. Consequently, the Tax Court accepted the prior stipulated decision as written, adjusting outside basis to zero and applying a 40% gross valuation misstatement penalty thereto.

Background

The Tax Court in *Petaluma FX Partners, LLC et al. v. Comm'r*, 131 T.C. 84 (2008) (*Petaluma I*), held that outside basis is a partnership item when the partnership is a sham because no partner-level determinations are necessary. In *Petaluma II*, the D.C. Circuit reversed the Tax Court, holding that outside basis and penalties applicable thereto are affected items and not within a court's jurisdiction in a partnership-level proceeding. The D.C. Circuit then remanded the case to the Tax Court for it to determine whether any penalties could be computed without partner-level proceedings. On remand, the Tax Court held in *Petaluma FX Partners, LLC et al. v. Comm'r*, 135 T.C. 581 (2010) (*Petaluma III*), that it has jurisdiction at the partnership level only over penalties that relate directly to numerical adjustments to partnership items, and, therefore, no penalties could be determined in that partnership-level proceeding.

In *Tigers Eye* Tax Court Holds *Golsen* Rule Inapplicable

At first blush, it would appear that the main question presented in *Tigers Eye*—whether outside basis is a partnership item—was answered in *Petaluma II*, where the D.C. Circuit held (in a very similar transaction) that it was not. In such circumstances, the Tax Court's review of a case would usually be restrained by the *Golsen* rule. (The *Golsen* rule is a doctrine that the Tax Court laid out in *Golsen v. Comm'r*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir.1971), in which the Tax Court obliged itself to follow binding precedent of the Court of Appeals for which a case is appealable). The Tax Court, however, found that the *Golsen* rule was inapplicable because the Tax Court's decision in *Tigers Eye*, although not following *Petaluma II*, would not face the prospect of "inevitable reversal."

The Tax Court found that it could issue an opinion in *Tigers Eye* contrary to the holding in *Petaluma II* and not face the prospect of inevitable reversal because the D.C. Circuit had failed to consider regulations applicable to the jurisdictional issue of whether outside basis is a partnership item determinable in a partnership-level proceeding. The Tax Court determined that the D.C. Circuit in *Petaluma II* failed to consider the applicable regulations due to the government's concession in *Petaluma II* that outside basis is an affected item and not a partnership item. In a dissenting opinion, Judge Mark V. Holmes disagreed with the majority's conclusion that the D.C. Circuit had failed to consider whether outside basis is a partnership item under the regulations and noted that the D.C. Circuit cited the key regulation three times.

Although the government conceded in *Tigers Eye*, just as in *Petaluma II*, that outside basis is an affected item, the Tax Court rejected the government's concession. The Tax Court found that it could not accept the concession because it was a concession of law that waives the Tax Court's subject-matter jurisdiction, which cannot be waived or enlarged by a party or court. The Tax Court also found that, while the parties had not requested that the Court inquire as to whether outside basis is a partnership item under the

regulations, the Tax Court had an independent obligation to determine whether subject-matter jurisdiction existed, which hinged on whether outside basis was a partnership item.

In addition to determining that the D.C. Circuit had not considered the applicable regulations, the Tax Court held that a new legal landscape regarding deference to regulations meant that it must veer from its usual adherence to the *Golsen* rule. The Tax Court stated that the legal landscape regarding deference to regulations had changed since *Petaluma II* due to the intervening U.S. Supreme Court decision in *Mayo Found. for Med. Educ. & Research v. U.S.*, 562 U.S. ___, 131 S. Ct. 704 (2011) and the D.C. Circuit decision in *Intermountain Ins. Serv. of Vail, LLC v. Comm’r*, 650 F.3d 691 (D.C. Cir. 2011). The Tax Court found that *Mayo* and *Intermountain* required the Tax Court to defer to regulations that interpret the Tax Code, rather than follow earlier case law, unless the regulations failed to meet the two-step standard of *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-843 (1984). The Tax Court reviewed the regulations on point, specifically Treasury Regulations §§ 301.6231(a)(3)-1(a)(4) and (c), and 301.6233-1T(a) and (c), and found them valid under the two-step *Chevron* standard. The Tax Court then held that because the regulations were both valid and had not been considered by the D.C. Circuit in *Petaluma II*, the Tax Court was not bound to follow *Petaluma II*. Although the applicable regulations are arguably unclear and the IRS has interpreted them to mean that outside basis is generally a non-partnership item, the Tax Court held that the outside basis in *Tigers Eye* is a partnership item under those same regulations.

Dissenting Opinions Fault Majority

The *Tigers Eye* decision included several concurring and dissenting opinions. The most vocal of these, authored by Judge Holmes, accused the majority of brazenly challenging binding circuit court precedent and overruling applicable Tax Court precedent. Incidentally, in response to a statement by Judge Holmes that “[o]ur decision today overrules *Petaluma III*,” the D.C. Circuit recently remanded what would have been *Petaluma IV* to the Tax Court for it to determine and explain the current status of *Petaluma III*. See *Petaluma FX Partners, LLC, et al. v. Comm’r*, No. 11-1084 (D.C. Cir. Feb. 27, 2012), *per curiam* (non-published).

Conclusion

With a highly divided Tax Court in *Tigers Eye* and seemingly contrary precedent in the D.C. Circuit, an appeal of *Tigers Eye* to the D.C. Circuit would appear to be a certainty. If *Tigers Eye* is appealed, then our best guess is that the result will likely be, as described by Judge Holmes in his dissenting opinion, either a reversal by the D.C. Circuit on the grounds that *Petaluma II* must be followed as *stare decisis* or a full *en banc* review by the D.C. Circuit to determine whether *Petaluma II* should be overturned. In any event, the final chapter of *Tigers Eye* has probably yet to be written.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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