

Ethics and Tax Procedure Corner

By Thomas Greenaway¹

Court Leaves Government with Limited Options in Partnership Case



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Partnership tax practitioners wrestle with the aggregate-entity duality in almost all aspects of their work—including IRS controversies. In an echo of substantive partnership tax, TEFRA partnership² proceedings divide reality in two: “partnership items” (*i.e.*, items that demand entity-level determinations) and “non-partnership items” (*i.e.*, items that are determined partner-by-partner). The general rule, consistent with the doctrine of *res judicata*, holds that both the IRS and partners are generally bound by the treatment of entity-level partnership items on the partnership return³ or as redetermined in a TEFRA partnership proceeding.⁴ The flipside to that rule provides that unless an item is a “partnership item,” neither the IRS nor the courts have jurisdiction to redetermine the item in a TEFRA partnership proceeding.

For years, the IRS has been arguing for a broad reading of the term “partnership item” in TEFRA litigation. For the most part, the courts have adopted the IRS’s arguments concerning a broad application of partnership items, most notably with respect to the statute of limitations⁵ and the question of whether a partnership was valid or whether it is a sham lacking economic substance.⁶ The government has used this approach as it has investigated partnership-driven tax strategies prevalent during the late 1990s and early 2000s.

But in a recent case, *Alpha I, L.P.*,⁷ the Court of Federal Claims rejected the IRS’s broad-reaching interpretation of the term “partnership item.” The court’s decision could signal a need for a revision of the IRS’s approach in these types of cases.

Here is a simplified version of the facts. Alpha I, L.P. had four equal limited partners: three individuals and one partnership. Consequently, it was a TEFRA

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partnership.⁸ The partnership did not have a Code Sec. 754 election in place. The partnership held about \$350,000 in cash and about 2 million shares in a Fortune 500 company. On Date 1, each of the four limited partners transferred their partnership interests to one of four different Charitable Remainder Unitrusts (“CRUTs”). The partnership allocations did not change. Just over a week later, on Date 2, the partnership sold all 2 million shares for about \$75 million. On their individual income tax returns, the original partners claimed charitable contribution deductions for the transfers of the partnership interests to the CRUTs. On the partnership income tax return, Alpha I, L.P. reported basis of about \$95 million in the sold shares.

The IRS issued a Final Partnership Administrative Adjustment (“FPAA”), the TEFRA equivalent of a notice of deficiency, shamming the entire set of transactions, beginning with the original transfers of the partnership interests to the CRUTs. Furthermore, the IRS adjusted the basis in the stock down to \$9 million. The partnership originally reported a \$20 million loss on the stock sale, but the IRS redetermined that the sale resulted in a \$66 million gain. The IRS, however, did not take the precautionary measure of issuing protective notices of deficiencies against the original partners on the contingency that a court would not sustain the government’s position that the identity of the partner and other items were, in fact, partnership items.⁹

Sands, one of the original partners, paid the requisite deposit and filed a petition for redetermination of the FPAA in the Court of Federal Claims.¹⁰ In time, Sands filed a motion with the court to: (1) invalidate that portion of the FPAA that purported to sham the transfers of the partnership interests from the original partners to the CRUTs; (2) dismiss him from the case; and (3) order the IRS to refund his deposit. Sands argued that the question of whether the transfers of the partnership interests were economic shams is not a “partnership item” for two reasons. First, in this case, where respective partnership allocations did not change and there was no Code Sec. 754 election in place, the transfer of a partner’s interest is of no tax consequence to the partnership or any other partner. Second, the identity of a partner is not

included on the list of partnership items enumerated in the regulations.

The government objected to the motion. The government argued that the identity of a partner “fundamentally affects the partnership as a whole.” The government also argued by analogy from its relatively successful TEFRA statute-of-limitations cases, specifically *M.A. Weiner*,¹¹ for the proposition that the identity of a partner is “implicitly” included in the regulations defining what constitutes a partnership item. In the alternative, the government argued that the transfers were “affected items.” The Code’s definition of the term “affected item” as “any item to the extent it is affected by a partnership item”¹² does not provide clarification. The regulations provide no additional guidance in this context.

The court, after a careful review of the regulations and the cases, decided in the taxpayer’s favor.

The court invalidated the portion of the FPAA that purported to sham the transfers of the partnership interests, dismissed Sands from the case and named one of the CRUTs as the filing partner. (The court found no grounds to order a refund of the deposit, however, until the

entire action is dismissed.) The court also addressed the government’s affected-item argument, concluding that the identity of the partners was not even an affected item.

The government then filed a precatory motion for reconsideration. The government argued that if the court’s original ruling stood, the identity of the partners would escape judicial review forever, since the time had already expired to issue a notice of deficiency to the original partners. The government reasserted its original arguments, including that the identity of the partners is an item “more appropriately determined” at the partnership level. Finally, the government belatedly agreed with the taxpayers that the court did not have jurisdiction in a TEFRA partnership proceeding to decide whether a nonpartnership item is an affected item.

The court was not swayed by the government’s motion for reconsideration,¹³ as the government had not shown an intervening change in law, new evidence or manifest injustice. The court did, however, amend the earlier order to withdraw the discussion regarding

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whether the identity of the partners was an affected item—and the conclusion that it was not.

For the time being then, the government is left with a diminished case. Even if the government wins on the merits, any adjustment will be passed through to the CRUTs, which generally do not pay income tax. But it seems unlikely that the government will concede. An appeal by the government, either interlocutory if permitted or after the entry of judgment, seems likely in this case.

The more interesting question is what the IRS will do with its affected item argument. The IRS has long argued for a broad interpretation of the term “affected item,”¹⁴ just as it argues for a broad interpretation of the term “partnership item.” Under TEFRA, the IRS has up to one year after the conclusion of a TEFRA partnership proceeding to assess any affected items.¹⁵ Accordingly, the IRS can—and does—issue notices of deficiency to partners after TEFRA partnership proceedings become final, proposing to assess affected items that require partner-level determinations.

But here, the government may have missed its chance. It did not issue timely notices of deficiency to the original partners, perhaps out of fealty to its broad interpretation of the terms “partnership item” and “affected item.” Now that the government has lost, at least initially, the partnership item argument, it will have to rely upon its affected item argument. As the government pointed out in its motion for reconsideration, however, a redetermination of the identity of a partner would have no tax effect. The IRS obviously cannot issue a notice of deficiency proposing to assess a zero deficiency. The tax effect of this supposed affected item—the identity of the partners—is zero.

A common-sense approach to the term “affected item” would suggest that there can be no such thing as an affected item with zero tax effect. But as we all know, partnership taxation does not always rely on common sense. In the aftermath of the shelter litigation, and as the IRS heats up its examinations of partnerships, these questions will become all the more important.

ENDNOTES

¹ The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author only, and does not necessarily represent the views or professional advice of KPMG LLP.

² TEFRA partnerships are those partnerships that fall within the unified audit and litigation procedures enacted by the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”) (P.L. 97-248). These provisions are found in Code Secs. 6221 through 6233. The TEFRA partnership provisions are effective for partnership tax years beginning after September 3, 1982, and generally apply to

partnerships that have more than 10 partners at one time during the tax year or that have any partner that is a passthrough entity. Code Sec. 6321(a)(1).

³ Code Sec. 6222(a).

⁴ See Code Secs. 6224(c)(3) and 6226(c)(1).

⁵ *E.g.*, *J. Chimblo*, CA-2, 99-1 ustr ¶ 50,540, 177 F3d 119.

⁶ *E.g.*, *RJT Investments X*, CA-8, 2007-2 ustr ¶ 50,535, 491 F3d 732.

⁷ *Alpha I, L.P.*, 2008-2 ustr ¶ 50,595, 84 FedCl 209.

⁸ The partnership also had a nominal general partnership interest.

⁹ Presumably, even if the IRS *had* issued a notice of deficiency, the IRS would have moved to dismiss any resulting petition from Tax Court, on the ground that the items in issue

were all either partnership or affected items. See, e.g., *Miller*, TC Memo 2009-182.

¹⁰ Six other partners—including one of the CRUTs—also filed TEFRA redetermination actions in the Court of Federal Claims. Their cases were consolidated.

¹¹ *M.A. Weiner*, CA-5, 2005-1 ustr ¶ 50,137, 389 F3d 152.

¹² Code Sec. 6231(a)(5).

¹³ *Alpha I, L.P. v. United States*, 86 Fed. Cl. 126 (2009).

¹⁴ See, e.g., *R.J. Goldberg*, 93 TCM 1081, Dec. 56,890(M), TC Memo 2007-81; *J.C. Bedrosian*, 94 TCM 614, Dec. 57,210(M), TC Memo 2007-375.

¹⁵ Code Sec. 6229(a)-(d)(2).

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