

MSCPA Federal Tax Forum Update  
Partnership Update

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10. Partnership and partner transactions—intent—business purpose; state vs. federal tax savings—disguised sales.

**The following information was taken from RIA Checkpoint from the period of January 1, 2011 through August 30, 2011.**

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Federal Taxes Weekly Alert Newsletter

2011

05/19/2011 - Volume 57, No. 20

In Brief

[Code Sec. 761 Partnerships—partnerships as partner—proof—gross income—ordinary income vs. capital gain—refunds. \(05/19/2011\)](#)

**Federal Taxes Weekly Alert,**

**Partnerships—partnerships as partner—proof—gross income—ordinary income vs. capital gain—refunds.**

Energy assets management partnership partner and spouse were denied refund claim to treat as capital gain rather than ordinary income their distributive share of performance fee income received by partnership in connection with sale of assets which partnership managed for and which were owned by another entity/LLC: taxpayers' claim was based on premise that partnership was itself in partnership relationship with LLC, but overall evidence showed to contrary/showed that no such relationship existed and instead that partnership and LLC were just operating pursuant to service relationship/management agreement. Evidence included that management agreement expressly disavowed any partnership relationship between partnership and LLC and that although numerous, partnership's responsibilities didn't extend into key areas of acquiring and disposing of assets or drawing on LLC's bank accounts. It was also telling that partnership didn't own title to any of LLC's assets, didn't hold itself out as partner, couldn't make significant business decisions, was entitled only to performance fee as compensations for its services, and wouldn't have to pay back amounts obtained under nonrecourse promissory note if asset portfolio that it was managing performed poorly. Although there were some counter-factors pointing to partnership relationship, such as existence of clawback arrangement, such weren't dispositive in face of other evidence. (Rigas v. U.S., DC TX, [107 AFTR 2d ¶2011-788](#) )

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2. Checkpoint Contents

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Federal Editorial Materials

Federal Taxes Weekly Alert Newsletter

2011

06/02/2011 - Volume 57, No. 22

Articles

[TEFRA-partnership refunds: five steps to protect a partner's rights \(06/02/2011\)](#)

**Federal Taxes Weekly Alert,**

**TEFRA-partnership refunds: five steps to protect a partner's rights**

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The procedures governing refund claims involving TEFRA partnerships are complex, but as this *Practice Alert* (excerpted from a more extensive article in the [January/February 2011 issue of Business Entities](#)) explains, there are five steps a partner can take to protect its interests.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) established a unified procedure for determining the tax treatment of partnership items at the partnership level rather than the partner level. The TEFRA-partnership refund procedures differ from the refund claim procedures that apply to other taxpayers. For a TEFRA partnership, a refund claim is an administrative adjustment request (AAR), and a notice of deficiency is a notice of final partnership administrative adjustment (FPAA). Procedures for the assessment of additional tax attributable to partnership items have received much attention in recent years, but the procedures concerning refunds are complex and full of traps.

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The tax matters partner (TMP) plays a key role in protecting the partners' rights, but the TMP's interests may differ significantly from those of other partners. Because of potential conflicts of interest, an individual partner should not rely entirely on the TMP. This *Practice Alert* recommends five steps a taxpayer should take to protect its rights to refunds in a TEFRA partnership:

- (1) File an AAR before the IRS issues an FPAA—otherwise it will be too late.
- (2) Review the statutes of limitations for AARs carefully, as they differ from other limitations periods.
- (3) File a separate AAR and do not rely entirely on the AAR filed by the TMP.
- (4) Consider extending the partner-level statute of limitations for assessment to avoid forfeiting potential refund claims.
- (5) If beyond the period of limitations, consider alternative methods of recovery.

**Step 1: File an AAR before IRS issues an FPAA.** Before IRS proposes adjustments, taxpayers can simply request refunds, whether by a refund claim or AAR. Different procedures apply to taxpayer-initiated adjustments once a notice of deficiency or its equivalent, an FPAA, is issued. The different procedures create a potential pitfall to TEFRA-partnership taxpayers. Outside of the TEFRA-partnership context, IRS issues a notice of deficiency when it determines that the tax properly due is more than that previously reported or assessed. ([Code Sec. 6212](#)) The taxpayer can file a petition with the Tax Court to redetermine the deficiency ([Code Sec. 6213](#)) or, alternatively, wait for the assessment, pay the assessed amount, and then pursue a refund. To do so, the taxpayer files a refund claim. ([Code Sec. 6511](#)) If the claim is not allowed, that taxpayer may file a refund suit in district court or the Court of Federal Claims. ([Code Sec. 7422](#))

The TEFRA procedures are quite different, so a taxpayer must be careful not to unwittingly waive its rights. Once IRS issues an FPAA, partners may no longer file an AAR. ([Code Sec. 6227\(a\)\(2\)](#)) Instead, the TMP or, if it fails to do so, any other partner, may file a petition for a readjustment of partnership items in response to the FPAA. ([Code Sec. 6226\(a\)](#)) The court in which the petition is filed has jurisdiction to determine all partnership items ([Code Sec. 6226\(f\)](#)), so the taxpayer can litigate items totally unrelated to the FPAA. In effect, this procedure is an adequate alternative to filing an AAR, but it is the taxpayer's only alternative for pursuing refund items once IRS issues the FPAA and comes with quicker deadlines. A

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TEFRA partnership does not have the option of paying the amount in the FPAA and then filing a claim for refund within the next two years.

**Step 2: Review the statute of limitations for AARs carefully.** There are some key differences between the statutes of limitations for filing an AAR and refund statutes of limitations for non-TEFRA-partnership taxpayers. A partner who assumes that the AAR limitations periods follow familiar patterns may be unpleasantly surprised. As the law concerning the statute of limitations for assessments is important in understanding the AAR limitations periods, it is addressed first.

The general requirement for non-TEFRA-partnership taxpayers is that IRS must assess additional tax within three years from when the return is filed. ([Code Sec. 6501\(a\)](#)) The TEFRA procedures include a separate limitations provision for assessments relating to partnership items. With some exceptions, the TEFRA period for assessing tax that is attributable to any partnership items (or affected items) “shall not expire before” three years after the later of the date the partnership return was filed or the last day for filing the return (determined without regard to extensions). Congress did not explain exactly how—if at all—the second limitations period (the “[Code Sec. 6229](#) period”) relates to the first limitations period (the “[Code Sec. 6501](#) period”). Is an assessment of additional tax to the partner, related to partnership items, timely if issued after the partnership-level [Code Sec. 6229](#) period expires but before the partner-level [Code Sec. 6501](#) period expires?

IRS adopted a “statute extension” theory, under which the TEFRA procedures merely extend the [Code Sec. 6501](#) period for assessments related to partnership items. An assessment of tax attributable to a partnership item is timely as long as the partner's [Code Sec. 6501](#) period is open, even if the partnership's [Code Sec. 6229](#) period has expired. In 2000, based on the “shall not expire before” language quoted above, the Tax Court agreed with IRS. The Tax Court concluded that the two sections provide “alternative periods within which to assess tax with respect to partnership items, with the later-expiring period governing in a particular case.” (Rhone-Poulenc Surfactants & Specialties, L.P. (2000), [114 TC 533](#) )

*Statute of limitations for filing an AAR.* [Code Sec. 6227](#) requires an AAR to be filed within three years from when the partnership return was filed or within an extended period agreed on by the partnership and IRS. Taxpayers may reasonably assume that the TEFRA limitations period for filing an AAR set forth in [Code Sec. 6227](#) is interpreted similarly to the period of limitations for assessments: a partner can file an

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AAR even if the partnership-level [Code Sec. 6227](#) period has expired, as long as the general limitations period for filing partner-level refund claims set forth in [Code Sec. 6511](#) is still open. These limitations periods may be different, unless the partner extends its own statute of limitations for partnership items. IRS has never addressed the interaction of the partner-level and the partnership-level limitations period in the context of AARs, and the only court to consider the issue has rejected the “statute extension” theory. As a result, an AAR filed after the partnership-level limitations period expires may be untimely, even though the partner-level limitations period remains open.

*Statute of limitations for allowing a refund.* In addition to the statute of limitations for filing an AAR, there is a second limitations period that is relevant to refunds. [Code Sec. 6230\(d\)\(1\)](#) limits when the IRS may allow partners credits or refunds of overpayments attributable to partnership items: Except as otherwise provided, no credit or refund of an overpayment attributable to a partnership item (or an affected item) for a partnership tax year shall be allowed or made to any partner after the expiration of the period of limitation prescribed in [Code Sec. 6229](#) with respect to such partner for assessment of any tax attributable to such item.

[Code Sec. 6230\(d\)\(1\)](#) was most likely enacted because IRS may allow refunds to partners for partnership items even without AARs. For instance, IRS may allow a refund as a result of a computational adjustment or as the result of an audit or resolution of an FPAA.

*Statute of limitations for judicial review.* Even after an AAR has been timely filed, one further statute of limitations trap awaits. Outside the TEFRA context, taxpayers can file a refund suit within two years after a refund claim is disallowed. ([Code Sec. 6532](#)) A cursory reading of the procedures might lead to the assumption that the same rule applies within the TEFRA context, but it does not. A partner or partnership must file suit contesting the disallowance of an AAR not within two years of the disallowance of the claim, but within two years of the date the AAR was filed.

*Two essential points.* First, do not assume that a partner can still file an AAR as long as the partner-level statute of limitations for assessment and refund claims is still open. While the partner-level statute of limitations allows IRS to make assessments of tax attributable to partnership items even after the partnership statute has closed, a similar rule does not apply to refunds. Therefore, a partner needs to file an AAR within three years after the partnership return is filed (or within the agreed extended period of limitations)—a partner should not wait until three years after the partner's return is filed.

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Second, do not assume that the statute of limitations for going to court remains open indefinitely if IRS does not formally disallow the AAR. That may be how things work for nonpartnership items, but it does not apply to partnership items. A partner needs to file a petition for judicial review within two years from when the AAR was filed.

**Step 3: File a separate AAR.** When a TMP files a petition for judicial review of an FPAA, the individual partners cannot also file a petition, but they automatically become parties to the petition filed by the TMP. ([Code Sec. 6226\(c\)](#)) If the TMP does not file a petition for redetermination of an FPAA, however, any individual partner may file suit. ([Code Sec. 6226\(b\)\(1\)](#)) Thus, no partner is ever barred from contesting an FPAA due to the TMP's failure to act.

If only the TMP files an AAR and IRS disallows it, only the TMP has the right to file a petition for an adjustment to the related partnership items. ([Code Sec. 6228\(a\)](#)) If the TMP does not file a petition for judicial review, the individual partners cannot do so. The other partners are completely dependent on the TMP if only the TMP files an AAR.

Because one partner is not entitled to an adjustment related to an AAR filed by another partner, no partner can count on receiving a benefit of an AAR filed by another partner. Although an AAR filed by the TMP will protect all other partners, an individual partner never has a guarantee that the TMP will act in its best interest. Individual partners can, however, always file their own AAR, even when the TMP or another partner files an AAR. Although IRS may reject the duplicative AAR, the partner would still have the right to file a petition for judicial review and not be entirely dependent on the TMP. Thus, it may be in an individual partner's best interests to file its own AAR rather than relying on the TMP or other partners.

**Step 4: Extend the partner-level limitations period for assessments.** While seemingly counter-intuitive, sometimes it makes sense to extend the statute of limitations for assessment of partnership items to avoid forfeiting potential claims that result from correlative adjustments to a related party.

There are two drawbacks to a partner agreeing to extend the period of limitations for assessments:

- (1) The extension agreement will allow IRS more time to conduct an audit of the partnership and to identify adjustments that may more than offset any potential refund items. A partner needs to evaluate its exposure carefully before deciding to extend the statute of limitations.

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(2) IRS must agree to the extension. IRS's policy is not to agree to an extension unless it is to the government's benefit. The Internal Revenue Manual states that IRS does not secure consents extending the period for assessment in cases involving claims or overassessments unless final disposition will possibly result in a deficiency or additional tax.

If there is no possibility of a deficiency in an overassessment case, advise the taxpayer in writing about protecting his or her interest by filing a protective claim for refund.

**Step 5: Consider alternative methods of recovery.** There are methods other than AARs or refund claims that partners may consider to recover an overpayment of taxes attributable to partnership items if, for some reason, an AAR or petition for judicial review is not available.

As noted above, IRS is directed to allow a credit or refund of a partner's overpayment attributable to a partnership item, even without a claim by the partner. These adjustments are at IRS's discretion when the partner did not file a timely AAR or petition for judicial review, but if a partner is beyond the limitations periods for filing an AAR or a petition for judicial review, it can request that IRS make a discretionary adjustment.

*Equitable recoupment.* Some potential refund items might relate to transactions between the partnership and a related party in which the partner also has an interest. For example, a transfer pricing adjustment in an audit of a related party might give rise to a refund item for the partnership and its partners. If so, there may be grounds for equitably recouping the barred refund adjustment to the partnership return against the assessment of the related party.

Equitable recoupment is a judicial doctrine that allows the recovery of amounts otherwise barred by the statute of limitations under certain conditions: First, a single transaction must be the taxable event to be considered in recoupment. Second, the single transaction must be subject to two taxes based on inconsistent legal theories. Finally, the statute of limitations must bar recoupment, while either the government's asserted deficiency or the taxpayer's claim for a refund must be timely.

Although equitable recoupment normally applies when a single transaction is subject to two taxes imposed on the same taxpayer, it has been extended in some instances to separate taxpayers "where there is a clear identity of interests between them, such that the benefits and detriments to one party inure

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exclusively to the other.” Therefore, depending on the circumstances, a partner should consider requesting equitable recoupment against the assessment of a related party concerning a transaction between that related party and the partnership.

*Mitigation.* The mitigation provisions of the Code perform a function similar to the judicial doctrine of equitable recoupment, by allowing the recovery of amounts otherwise barred by the statute of limitations. Equitable recoupment may be available to redress inconsistent treatment of transactions between the partnership and a related party in which the partner also has an interest. Mitigation, however, has different requirements.

When inconsistent positions are taken on the returns of two different taxpayers rather than two different tax years for the same taxpayer, mitigation is available only when the two taxpayers are “related.” Under [Code Sec. 1313\(c\)\(6\)](#), “partner” is included in the definition of related taxpayers. That provision is normally interpreted to address the relationship between two partners in a partnership rather than between a partnership and one of its partners. As a result, mitigation usually will apply to inconsistent treatment of transactions between two partners in a partnership, but not between the partnership and its partners.

**Conclusion.** The TEFRA procedures for AARs provide all partners a way to recover overpayments attributable to partnership items. The procedures are complex, however, with many potential pitfalls. Any partner who identifies a potential refund item for the partnership should thoroughly review all of the applicable requirements and carefully assess what it must do to preserve its rights. In particular, a partner may find it beneficial to file its own AAR, or include refund items in a petition for readjustment of an FPAA, in case the TMP cannot or will not act in the partner's interests. Under some circumstances, it may even be appropriate for a partner to extend its own statute of limitations to protect its interests.

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05/19/2011 - Volume 57, No. 20

In Brief

[Code Sec. 704 Partnership losses—partner's distributive share—adjusted basis—assumption of liabilities—proof. \(05/19/2011\)](#)

Federal Taxes Weekly Alert,

**Partnership losses—partner's distributive share—adjusted basis—assumption of liabilities—proof.**

IRS's determination to 50% owner of multiple LLCs/partnerships and wife weren't entitled to deduction for husband's share of partnership losses was upheld: taxpayers didn't show that husband had any basis supporting loss. Argument that husband assumed portion of partnership liabilities and that there was judgment regarding same which could be enforced against him was belied by lack of proof that partnership even had any liabilities or that husband in fact assumed same. (William P. Crouse, Jr., et ux. v. Commissioner, (2011) [TC Memo 2011-97](#), 2011 RIA TC Memo ¶2011-97 )

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Federal Taxes Weekly Alert Newsletter

2011

04/07/2011 - Volume 57, No. 14

Articles

[Partnership contributions for allocations of state tax credits were disguised sales \(04/07/2011\)](#)

Federal Taxes Weekly Alert,

**Partnership contributions for allocations of state tax credits were disguised sales**

**Virginia Historic Tax Credit Fund 2001 LP, (CA 4 03/29/2011) [107 AFTR 2d ¶ 2011-633](#)**

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The Court of Appeals for the Fourth Circuit, reversing the Tax Court, has held that the [Code Sec. 707](#) disguised sales rules applied where investors contributed cash to partnerships engaged in rehabilitating historic buildings and were allocated state tax credits from the partnership.

*Facts.* The cost of renovating historic property often exceeds the property's market value. Because of this, Virginia, like other states, has a program to encourage historic renovations. Under the Virginia program, a developer meeting certain conditions can receive tax credits of up to 25% of eligible expenses incurred in renovating the property. These tax credits can be applied dollar-for-dollar against Virginia income tax liability.

In general, Virginia does not allow tax credits to be sold or transferred in the event they exceed a developer's income. It does, however, permit state tax credits allocated to a partnership to be divided among the partners as they may agree. Developers have used this provision to allocate credits to limited partners. Also, Virginia allowed for a one-time transfer (i.e., sale) of credits for projects that received certification before the publication of final regs.

Despite the Virginia program, smaller historic renovation projects were having difficulty obtaining funding. Because of this, three individuals formed partnerships that investors could join by contributing capital. These partnerships included Virginia Historic Tax Credit Fund 2001 LP, Virginia Historic Tax Credit Fund 2001 SCP, LLC and Virginia Historic Tax Credit Fund 2001, SCP, LP (“the Funds”). The Funds would use that capital to partner with historic property developers renovating smaller projects in exchange for state tax credits.

During an audit, IRS challenged the way that Virginia Historic Tax Credit Fund 2001, LLC, as the Funds' tax matters partner, reported a series of transactions with investor partners in the Funds' 2001 and 2002 federal tax returns. The Funds reported the investors' contributions as nontaxable contributions to capital. IRS contended that the investors were not partners and that the transactions were sales of income tax credits to the investors. Accordingly, IRS said that the Funds should have reported the money they received from investors as income.

The matter wound up in Tax Court, where IRS put forth two arguments: (1) under the substance-over-form doctrine, the investors were not “bona fide” partners in the Funds for federal tax purposes, but

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instead were mere purchasers; and (2) the transactions between the investors and the partnerships were disguised sales under [Code Sec. 707](#). The Tax Court found against IRS on both counts.

*Background.* Partners may contribute capital to a partnership tax free and may receive a tax free return of previously taxed profits through distributions. ( [Code Sec. 721](#), [Code Sec. 731](#).) These nonrecognition rules do not apply, however, where the transaction is found to be a disguised sale of property. ( [Code Sec. 707\(a\)\(2\)\(B\)](#).) A disguised sale can occur if:

- (1) there is a direct or indirect transfer of property (including money) by a partner to a partnership,
- (2) there is a related direct or indirect transfer of property (including money) by the partnership to that partner, and
- (3) when viewed together, both transfers are properly characterized as a sale or exchange of property.

If these conditions are met, then the transfers are to be treated either as a sale between the partnership and an outsider or as a transaction between two or more partners all of whom are acting outside of their capacities as partners. ( [Code Sec. 707\(a\)\(2\)\(B\)](#) ). [Reg. § 1.707-3](#) clarifies which partnership transfers should be properly characterized as a sale or exchange of property under [Code Sec. 707\(a\)\(2\)](#) . By its terms, [Reg. § 1.707-3](#) applies to transfers of property to a partnership in exchange for money from the partnership. However, under [Reg. § 1.707-6](#) , rules similar to those provided in [Reg. § 1.707-3](#) apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner.

[Reg. § 1.707-3](#) calls for an evaluation of all the facts and circumstances surrounding the transaction to determine whether:

- (i) the transfer of money or other consideration would not have been made but for the transfer of property; and
- (ii) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

[Reg. § 1.707-3](#) goes on to list ten factors to be taken into consideration.

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*Parties' arguments.* On appeal, IRS again argued that the investors were not bona fide partners of the Funds, and that even if they were, the transactions between the investors and the Funds should nevertheless be classified as sales under [Code Sec. 707](#). The Fourth Circuit assumed, without deciding, that the investors were bona fide partners. It then addressed IRS's argument that [Code Sec. 707](#) applied.

The Funds argued that [Code Sec. 707](#) could not be applied to recharacterize their transactions with investors because these transactions did not involve an exchange of money for property. Specifically, they argued that Virginia's historic rehabilitation tax credits were not property because they were nontransferable and non-inheritable under state law. There was thus, they argued, no "transfer of money or other property from the Funds to the investors."

*Tax credits were property.* The Court observed that the Code does not define property for purposes of [Code Sec. 707](#). This determination is a hybrid federal and state law question and is to be made by applying the factors set forth in *U.S. v. Craft, Sandra L.*, (2002, S Ct) [89 AFTR 2d 2002-2005](#), which held that a tax lien could attach to a spouse's interest in tenancy by the entirety (see [Weekly Alert ¶ 3 04/25/2002](#)). Applying the factors from *Craft*, the Fourth Circuit found that the transfer of tax credits from the Funds to investors constituted a transfer of property. It was clear on the facts that the Funds' tax credits were both "valuable" and imbued with "some of the most essential property rights."

*Transactions were sales.* Next, the Court turned to the question of whether these transfers should be properly recharacterized as "sales" under [Code Sec. 707](#) and the factors enumerated in [Reg. § 1.707-3](#). The Court said that five factors from the cited reg were relevant in this case. These factors (in italics) and the Court's evaluation of them follow:

*... The timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer.* The Court said this condition was met. When the investors signed partnership and subscriptions agreements and made their contributions to the Funds, the Funds promised them a precise number of tax credits in exchange, so that each investor knew with specificity the size of the subsequent transfer he or she could expect.

*... The transferor has a legally enforceable right to the subsequent transfer.* This factor also weighed in favor of finding a sale. The partnership and subscriptions agreements between the Funds and their investors explicitly promised delivery of tax credits to investors in exchange for

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capital contributions. Had the Funds acquired tax credits that they then refused to allocate to the investors, the investors could have pursued a breach of contract claim against them.

*... The partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured.* The Court said that the investors' contributions were secured in several ways. For example, the Funds promised that investor capital would be refunded if sufficient credits could not be obtained or were revoked.

*... The transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits.* The Court stressed that this factor strongly suggested a disguised sale. The investors had essentially no interest in partnership profits under their arrangement with the Funds. The transfer of tax credits to each investor by the partnership had no correlation to each investor's interest in partnership profits whatsoever.

*... The partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.* This condition was met, said the Court. After receiving the tax credits, the investors had no further obligations or relationship with the partnership. Instead, they were free to use the credits for their own benefit.

Accordingly, the Court found that the transactions constituted disguised sales under [Code Sec. 707](#).

**References:** For partnership disguised sales, see [FTC 2d/FIN ¶ B-2100](#) et seq.; [United States Tax Reporter ¶ 7074.02](#); [TaxDesk ¶ 585,000](#) et seq.; [TG ¶ 2054](#).

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### 5. Checkpoint Contents

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Federal Taxes Weekly Alert Newsletter

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02/17/2011 - Volume 57, No. 7

In Brief

MSCPA Federal Tax Forum Update  
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[Code Sec. 1401 Self-employment tax—net earnings from self-employment—partnership income and partner's distributive share—limited partner exclusion—limited partnership vs. limited liability partnership. . . . . \(02/17/2011\)](#)

Federal Taxes Weekly Alert,

**Self-employment tax—net earnings from self-employment—partnership income and partner's distributive share—limited partner exclusion—limited partnership vs. limited liability partnership.**

:Law firm/limited liability partnership's individual partners' distributive shares of firm's net business income from legal services were subject to self-employment tax: rejecting taxpayers' argument for [Code Sec. 1402\(a\)\(13\)](#) limited partner exclusion from [Code Sec. 1402\(a\)](#)'s general self-employment income rule, Tax Court examined differing natures of limited partnerships (LPs) and limited liability partnership (LLPs) and found that exclusion was intended only for individuals who merely invest in but don't actively participate in partnership business operations, not for individuals who perform services for partnership in their capacity as partners/act in manner of self-employed persons. And in this case, it was clear that these individual partners had performed legal services for firm in their capacity as partners and that their distributive shares were attributable to same rather than merely to return on investment. Thus, exclusion wasn't available and tax applied. (Renkemeyer, Campbell & Weaver, Llp, et al. v. Commissioner, [136 TC No. 7](#))

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6. Checkpoint Contents

Federal Library

Federal Editorial Materials

Federal Taxes Weekly Alert Newsletter

2011

08/18/2011 - Volume 57, No. 33

In Brief

[Code Sec. 6226 Partnership petitions—jurisdiction—multiple petitions—tax matters partner—partner status. \(08/18/2011\)](#)

Federal Taxes Weekly Alert,

**Partnership petitions—jurisdiction—multiple petitions—tax matters  
partner—partner status.**

Tax Court decision granting IRS jurisdictional dismissal of 2d partnership petition filed by individual owner of corp./TMP after TMP had already filed timely petition was affirmed: owner's argument that partnership wasn't partnership, raised for first time on appeal, wasn't considered; and his argument that corp. couldn't be TMP because its relationship to partnership was one of agency, not partnership was rejected.

Evidence showed that TMP acquired assignable interest in partnership by virtue of having invested cash in exchange for interest in partnership's net revenues; that partnership's return identified corp. as TMP; and that owner represented to IRS that corp. was TMP when, acting on corp.'s behalf, he executed IRS form used to extend limitations periods on making partnership adjustments. (Devonian Program v.

Comm., CA 3, [108 AFTR 2d 2011-5613](#) )

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Federal Taxes Weekly Alert Newsletter

2011

05/12/2011 - Volume 57, No. 19

In Brief

[Code Sec. 6662 Accuracy-related gross valuation misstatement penalties—partnership contributions; tax shelters—sham nature of partnership; outside basis—items relating to partnership items—negligence . . . . . \(05/12/2011\)](#)

**Federal Taxes Weekly Alert,**

**Accuracy-related gross valuation misstatement penalties—  
partnership contributions; tax shelters—sham nature of partnership;  
outside basis—items relating to partnership items—negligence and  
substantial understatement penalties—reliance on tax advisors—  
substantial authority—reasonable cause exception—partnership and  
partner transactions.**

On remand, Court of Federal Claims determined that it had no jurisdiction in partnership-level, tax shelter-related case to decide applicability of accuracy-related gross valuation misstatement (GVM) penalties because such couldn't be computed without looking to partners' outside bases/nonpartnership items: govt., which was arguing for jurisdiction and had burden of showing that there was some other item that could support penalties' application at partnership level, failed to do so and instead misfocused its position on such things as underlying sham partnership finding to support penalties, but such finding/item wouldn't in itself provide jurisdiction to determine GVM penalties at partnership level since those penalties were still all predicated on misstatements and erroneous reporting of partners' outside bases/nonpartnership items. Moreover, to extent govt. was trying to “backpedal” from its prior position and argue that GVM penalties related to inside basis/partnership item, its arguments weren't persuasive. Alternative arguments, that even if GVM penalties couldn't be decided, there was still jurisdiction to decide substantial understatement or negligence penalties, were also misguided.. (Jade Trading, LLC, et al. v. U.S., Ct Fed Cl, [107 AFTR 2d 2011-1832](#) )

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[Post-settlement assessments were computational adjustments; no deficiency notice needed](#)

[\(09/01/2011\)](#)

**Federal Taxes Weekly Alert,**

**Post-settlement assessments were computational adjustments; no deficiency notice needed Bush, (CA Fed Cir 8/24/2011) [108 AFTR 2d ¶ 2011-5217](#)**

The Court of Appeals for the Federal Circuit has determined in an en banc decision that IRS's post-settlement assessments made against a limited partner, arising from the disallowance of claimed partnership losses in excess of a stipulated at-risk amount, were computational adjustments under [Code Sec. 6231\(a\)\(6\)](#). The Court further found that no partner-level determinations were required in determining the taxpayer's liability under [Code Sec. 6230\(a\)\(2\)\(A\)\(i\)](#). Accordingly, IRS didn't err in assessing the subject taxes without first issuing a deficiency notice.

*Background on TEFRA audit rules.* Under the TEFRA partnership audit rules, the tax treatment of any “partnership item” (and the applicability of any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item) generally is to be determined at the partnership level. ( [Code Sec. 6221](#) ) If IRS decides to adjust any partnership items, it must notify the individual partners through a final partnership administrative adjustment (FPAA). ( [Code Sec. 6226](#) ) For 90 days after issuing an FPAA, the tax matters partner (TMP) has the exclusive right to file a petition for readjustment of the partnership items in the Tax Court, the Court of Federal Claims, or a U.S. District Court. ( [Code Sec. 6226\(a\)](#) ) After that period expires, other partners have 60 days to file a petition for readjustment. ( [Code Sec. 6226\(b\)\(1\)](#) )

Once a final partnership-level adjustment has been made to a partnership item, if there is no challenge to the FPAA, IRS may proceed to make corresponding computational adjustments to each partner's return. ( [Code Sec. 6231\(a\)\(6\)](#) ) Computational adjustments, which effectively apply the results of the partnership-level adjustments to the individual partners, are appropriate when the effect of the partnership items on the partner's tax liability can be computed mathematically without further partner-level determinations.

*Background on deficiency notices.* Deficiency procedures provided in [Code Sec. 6211](#) through [Code Sec. 6216](#), which include a notice requirement, generally don't apply to the assessment or collection of any computational adjustment ( [Code Sec. 6230\(a\)\(1\)](#) ), but do apply to “any deficiency attributable to... affected items which require partner level determinations ... other than penalties, additions to tax, and additional amounts that relate to adjustments to partnership items.” ( [Code Sec. 6230\(a\)\(2\)\(A\)](#) )

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However, if the partner's liability relates to affected items (i.e., any item to the extent the item is affected by a partnership item under [Code Sec. 6231\(a\)\(5\)](#)) requiring partner-level determinations, then IRS must send a notice of deficiency to that partner. For deficiencies other than those resulting from mathematical or clerical errors, IRS may not assess or collect the deficiency until it sends the deficiency notice and waits for the time for the taxpayer to file a Tax Court petition to expire (or if the taxpayer files a petition, until the Tax Court's decision becomes final). ( [Code Sec. 6213\(a\)](#) )

*Facts.* Lyman Bush was a limited partner in two partnerships in the early '80s. IRS found deficiencies in the partnerships' returns and, pursuant to TEFRA, notified the partners that it was issuing FPAAs disallowing certain deductions on the two partnerships' returns for '83—'86 and '85—'89, respectively.

While both partnerships challenged the FPAAs in the Tax Court, Bush settled with IRS on Aug. 7, '99, while the proceedings were pending. The Forms 906 (Closing Agreements on Final Determination Covering Specific Matters) stated that they did not make any adjustments to partnership items. The agreements provided that the settling partners were only entitled to claim partnership losses to the extent of their at-risk amount, and contained stipulations as to how to calculate that amount for the relevant tax years. Bush's capital contribution was set at \$50,000 per partnership, and the agreement stated that the at-risk amount could increase with any additional capital contribution to the partnership after '86.

On July 12, 2000, IRS issued Notices of Adjustment for Bush's '85, '86, and '87 tax returns disallowing a significant portion of the losses claimed in connection with the partnerships. Two weeks later, IRS assessed over \$150,000 in taxes and interest for those periods. These amounts were based on provisions in the closing agreements, and IRS didn't issue any deficiency notices before making the assessments. Bush paid the assessed tax and interest in August of 2000.

*Procedural history.* Two years later, Bush initiated refund proceedings to recover that payment on grounds that IRS failed to provide deficiency notices. IRS denied his claims, and Bush filed suit in the Court of Federal Claims on Oct. 25, 2004. The Court sided with IRS, holding that the post-settlement adjustments were computational adjustments for which no deficiency notice was required. (Bush, et al, v. U.S., (Ct Fed Cl 8/17/2007) [100 AFTR 2d 2007-5655](#) ) Bush timely appealed.

Bush's case was later affirmed by a divided panel on different grounds. (Bush v. U.S., (CA Fed Cir 3/31/2010) [105 AFTR 2d 2010-1687](#) ) The Federal Circuit found that the post-settlement assessments

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weren't computational adjustments, but held that IRS's failure to issue deficiency notices was harmless error.

However, this decision was subsequently vacated (*Bush v. U.S.*, (CA Fed Cir 10/29/2010) [106 AFTR 2d 2010-6909](#)), and the Federal Circuit agreed to rehear the appeal en banc. Among other things, the parties were specifically asked to address whether Bush was entitled to a pre-assessment deficiency notice under [Code Sec. 6213](#), and whether the assessments were the result of a computational adjustment.

*Court again rules in favor of IRS.* The Federal Circuit determined that IRS's assessments, based on the settlement, were computational adjustments under [Code Sec. 6231\(a\)\(6\)](#). The Court examined [Code Sec. 6231](#) and found IRS's broader interpretation, that "computational adjustments" are based on the proper *treatment* of a partnership item and not necessarily a change thereto, to be consistent with both the language of the statute and the purpose of TEFRA. Notably, the aim of TEFRA is to provide a single, unified forum in which every partner can participate to determine partnership items, and if a deficiency notice were required when the TEFRA proceeding results in a change in tax liability with no changes to the partnership items, this would effectively give individual partners a second opportunity to challenge the determination.

The Court also observed that its conclusion was supported by its reasoning in *Olson v. U.S.*, (CA Fed Cir 2/8/99) [83 AFTR 2d 99-759](#), which held that assessments are computational adjustments when they require "no individualized factual determinations" as to the correctness of the original partnership items or "any other factual matters." Under *Olson*, once critical questions of fact have been resolved, then "application of that stipulated fact to the tax returns in question requires only computational action." The Federal Circuit concluded that this reasoning applies with equal force to settlements.

The Federal Circuit found it telling that, if Bush hadn't settled and IRS had prevailed in the TEFRA proceeding, his claimed losses would have been invalid and IRS would have assessed the taxes via a computational adjustment. The fact that he instead chose to settle, and that the structure of the settlement resulted in no "changes" to partnership items, didn't alter the fact that the settlement nonetheless gave rise to a "change in tax liability of a partner which properly reflects the treatment ... of a partnership item." Thus, IRS's post-settlement assessments were in fact simple computational adjustments stemming from those agreements.

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The Court then turned to whether notices of deficiency were nonetheless due because the deficiencies were attributable to affected items requiring partner-level determinations under [Code Sec. 6230\(a\)\(2\)\(A\)\(i\)](#). The Court found that, contrary to Bush's argument, there were no partner-level determinations in this case. The settlements only required computation to determine his at-risk amounts, and in turn his liabilities. The fact that the at-risk amounts were specific to the individual partner didn't render them partner-level determinations under [Code Sec. 6230\(a\)\(2\)\(A\)\(i\)](#). Thus, no deficiency notices were required to assess Bush's deficiencies.

**References:** For computational adjustments not subject to regular deficiency procedures, see [FTC 2d/FIN ¶ T-2249](#); [United States Tax Reporter ¶ 62,214.09](#); [TaxDesk ¶ 825,262](#); [TG ¶ 70424](#).

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[CA9 upholds Tax Court's jurisdiction to determine Son of BOSS participant's deficiency \(09/01/2011\)](#)

**Federal Taxes Weekly Alert,**

### **CA9 upholds Tax Court's jurisdiction to determine Son of BOSS participant's deficiency**

**Napoliello, (CA 9 8/23/2011) [108 AFTR 2d ¶ 2011-5211](#)**

The Court of Appeals for the Ninth Circuit has affirmed a Tax Court decision upholding with minor adjustments IRS's deficiency determination against a Son of BOSS tax shelter participant. The Ninth Circuit rejected the taxpayer's attempts to undermine the Tax Court's jurisdiction, finding that the deficiency notice issued against him was valid and that the determination of the partnership's validity in the FPAA was a partnership item.

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*Background on TEFRA.* To remove the substantial administrative burden occasioned by duplicative audits and litigation, and to provide consistent treatment of partnership tax items among partners in the same partnership, Congress enacted the unified partnership audit and litigation procedures as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA, P.L. 97-248 ).

Under the TEFRA partnership procedures, before assessing the tax liability of the partners, IRS determines the tax treatment of partnership items in a partnership-level proceeding. ( [Code Sec. 6221](#) , [Code Sec. 6225](#) )

During the ninety-day period after the mailing of the Notice of Final Partnership Administrative Adjustment (FPAA), the tax matters partner (the "TMP") may file a petition for judicial review. ( [Code Sec. 6226\(a\)](#) ) If the TMP does not file a petition within that ninety-day period, any notice partner or any 5% group ( [Code Sec. 6231\(a\)\(11\)](#) ) may, within sixty days after the close of the TMP's ninety-day period, file a petition for judicial review. ( [Code Sec. 6226\(b\)](#) )

A partnership item is any item required to be taken into account for the entity's tax year under the Code's income tax provisions to the extent IRS regs provide that the item is more appropriately determined at the partnership level than at the partner level. ( [Code Sec. 6231\(a\)\(3\)](#) ) [Reg. § 301.6231\(a\)\(3\)-1](#) provides a list of such items. A nonpartnership item is an item that is (or is treated as) not a partnership item. ( [Code Sec. 6231\(a\)\(4\)](#) ) An affected item is any item to the extent the item is affected by a partnership item. ( [Code Sec. 6231\(a\)\(5\)](#) ) Although affected items by definition aren't partnership items and thus aren't determined in the partnership-level proceeding, they depend on partnership-level determinations.

[Code Sec. 6233](#) addresses instances in which a partnership return is filed, but the purported partnership either does not exist or is not actually a partnership. In those situations, [Code Sec. 6233](#) mandates that TEFRA's provisions still apply to the extent provided in regs.

*Background on notices of deficiency.* Once a final partnership-level adjustment has been made to a partnership item, if there is no challenge to the FPAA, IRS may proceed to make corresponding computational adjustments to each partner's return. ( [Code Sec. 6231\(a\)\(6\)](#) )

Deficiency procedures provided in [Code Sec. 6211](#) through [Code Sec. 6216](#) , which include a notice requirement, generally don't apply to the assessment or collection of any computational adjustment. (

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[Code Sec. 6230\(a\)\(1\)](#)) However, they do apply to “any deficiency attributable to... affected items which require partner level determinations ... other than penalties, additions to tax, and additional amounts that relate to adjustments to partnership items.” ([Code Sec. 6230\(a\)\(2\)\(A\)](#))

If the partner's liability relates to affected items requiring partner-level determinations, then IRS must send a notice of deficiency to that partner. For deficiencies other than those resulting from mathematical or clerical errors, IRS may not assess or collect the deficiency until it sends the deficiency notice and waits for the time for the taxpayer to file a Tax Court petition to expire (or if the taxpayer files a petition, until the Tax Court's decision becomes final). ([Code Sec. 6213\(a\)](#)) However, if the partner's liability doesn't relate to affected items requiring partner-level determinations, then IRS may directly assess the tax by making a computational adjustment.

*Facts.* Michael Napoliello participated in a Son of BOSS tax shelter in 2000. He established and became the sole member of an LLC and, on behalf of the LLC, entered into a series of transactions involving long and short foreign currency option contracts. Each long option had a premium of \$30 million and each short option had a premium of \$29.25 million. On Nov. 15, 2000, Napoliello exchanged his interest in the LLC for an interest in a recently-formed partnership, then subsequently withdrew from the partnership in exchange for shares of publicly-traded securities and \$392,492. Napoliello then sold the securities on Dec. 27, 2000 for \$358,296. As a result of the transactions, Napoliello reported \$60,942,026 in losses on his 2000 tax return, computed as the sales value of the securities less his basis in those securities (consisting of his claimed “outside basis” in the partnership at the time he withdrew, less the cash he received).

IRS determined that the partnership was a sham and sent it an FPAA on Dec. 3, 2004. The FPAA also made adjustments to the partnership's tax return, which included reducing its capital contributions, distributions of property other than money, and interest expense to zero. None of the partners contested the determinations in the FPAA.

On Apr. 28, 2006, IRS sent Napoliello a deficiency notice of \$12,072,927 for tax year 2000. The notice recalculated Napoliello's basis in the securities as \$358,383 (instead of the nearly \$62 million that Napoliello initially claimed) by accounting for the offsetting short options.

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Napoliello contested IRS's determinations in Tax Court, which entered summary judgment in favor of IRS and made minor adjustments to the amount owed. He then appealed the Tax Court's decision.

*Ninth Circuit affirms.* The Ninth Circuit rejected both of Napoliello's arguments raised on appeal and affirmed the Tax Court's judgment.

Napoliello's first argument was that, despite the fact that he and not IRS initiated the action, the Tax Court lacked jurisdiction because the deficiency notice issued to him was invalid. He claimed that, instead of issuing a deficiency notice, IRS should have made a direct computational adjustment against him. In effect, such a determination would strip IRS of its power to assess taxes based on that notice and render IRS unable to assess the tax by other means because the statute of limitations under [Code Sec. 6503\(a\)\(1\)](#) would have expired.

However, the Ninth Circuit found that IRS properly issued Napoliello a deficiency notice because the deficiency required a partner-level determination. In so holding, the Court looked to case law from other circuits and found that certain factual determinations were required before IRS could make a direct computational adjustment. (See Desmet et al, (CA6 09/17/2009) [104 AFTR 2d 2009-6456](#), at [Weekly Alert ¶ 9 09/24/2009](#))

The Ninth Circuit also rejected Napoliello's claim that the Tax Court lacked jurisdiction to redetermine the affected items in the deficiency notice that relied on the FPAA determination that the partnership was a sham. He claimed that the sham determination wasn't a "partnership item," so the Tax Court had no authority to redetermine items that were based on that determination. ([Code Sec. 6230\(a\)\(2\)\(A\)\(i\)](#), [Code Sec. 6231\(a\)](#)) However, the Ninth Circuit, agreeing with the District of Columbia and Eighth Circuits, found that a determination of a partnership's validity is in fact a partnership item. (See Petaluma FX Partners, LLC, (CA DC 01/12/2010) [105 AFTR 2d 2010-435](#), at [Weekly Alert ¶ 9 01/21/2010](#)) Notably, the validity of a partnership affects partners' tax liabilities and is a determination more appropriately made at the partnership-level under [Code Sec. 6231\(a\)\(3\)](#). Therefore, the Tax Court had jurisdiction to consider affected items that were based on this determination.

**References:** For the unified audit rules for partnerships, see [FTC 2d/FIN ¶ T-2100](#); [United States Tax Reporter ¶ 62,214](#); [TaxDesk ¶ 825,000](#); [TG ¶ 70400](#).

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In Brief

[Code Sec. 707 Partnership and partner transactions—intent—business purpose; state vs. federal tax savings—disguised sales. \(04/14/2011\)](#)

**Federal Taxes Weekly Alert,**

**Partnership and partner transactions—intent—business purpose; state vs. federal tax savings—disguised sales.**

4th Cir. determined that transactions between investors/partners and tiered partnerships involving historic rehabilitation projects, whereby investors/partners contributed cash to partnerships and were allocated state tax credits (STCs) in exchange, were properly recharacterized by IRS under [Code Sec. 707](#) and regs as taxable disguised sales/exchange of money for property/STCs. Rejecting taxpayers' argument that STCs weren't property for purposes of [Code Sec. 707](#), 4th Cir. found that being both valuable and imbued with some of most essential property rights, STCs clearly were property for [Code Sec. 707](#) purposes. Moreover, record belied Tax Court's underlying finding of entrepreneurial risk and instead showed that subject transactions met key reg factors for sales. Those factors included that timing and amount of STC transfers were “determinable with reasonable certainty” at time partnership contributions were made; that investors/partners had legally enforceable rights to STCs; that such were secured in several ways; that investors/partners had essentially no interest in partnership profits and transfer of their STCs were accordingly in no way correlated to partnership profits interests; and that investors/partners also had no obligation to return or repay partnership after transfers. (VA Historic Tax Credit Fund 2001, LP v. Comm., CA 4, [107 AFTR 2d 2011-1523](#) )

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