Internal Revenue Service
memorandum

CC:TL-6936-89
VWATERS

date: AUG 21 1989

to: District Counsel, Manhattan
Attn: Gail Campbell

from: Senior Technician Reviewer
Tax Shelter Branch CC:TL:TS

subject: [redacted]

This memorandum is in response to your request for tax litigation advice concerning whether the subject promotions should be classified as partnerships.

QUESTIONS PRESENTED

1. Whether the tax shelter promotions [redacted] (a co-tenancy), [redacted] and [redacted] (grantor trusts) should be classified as partnerships for purposes of the audit and litigation provisions of I.R.C. §§ 6221-6233 ("TEFRA")?

2. If the tax shelter promotions are classified as partnerships and the District Director's office decides to audit the partnerships, should the District Director file a substitute return for the partnerships and then issue FPAA's or should they issue a notice of deficiency to one of the investors whose [redacted] taxable year is not barred by the statute of limitations and then move to dismiss for lack of jurisdiction?

3. Whether similar tax shelter vehicles should be classified as partnerships subject to the unified audit and litigation provisions?

CONCLUSIONS

1. Each of the tax shelter promotions should be classified as a partnership for purposes of the audit and litigation provisions of TEFRA.

2. The tax treatment of items of partnership income, loss, deductions and credits is determined at the partnership level in a unified partnership level partnership proceeding. We agree

with your conclusion that the District Director should file a substitute return for the partnerships and issue Notices of Final Partnership Administrative Adjustment. The Service should not issue statutory notices to the investors since the normal deficiency procedures do not apply to TEFRA partnerships.

3. Whether a tax shelter vehicle should be classified as a partnership is a question of fact to be determined by looking at the individual facts and circumstances of the tax shelter. Therefore, we are unable to articulate a uniform position as to whether similar tax shelter vehicles should be classified as partnerships.

FACTS

Three tax shelter promotions, [redacted], [redacted] and [redacted], were organized as leveraged sale-leaseback co-ownership computer equipment programs. The initial year in all three programs is [redacted]. The individual investors in each program reported their losses for [redacted] on Schedule C's attached to their federal income tax returns. There is no indication that any of the individual investors were audited with respect to their investments in these three programs. One investor has extended the statute of limitations for the [redacted] taxable year and twelve other investors have signed agreements to waive the statute of limitations. The individual investor who extended the statute of limitations has a docketed case. Finally, the entities did not file partnership returns for taxable year [redacted] or any subsequent year.

I. [redacted]

The stated purpose of the [redacted] Program is to offer qualified owners the right to acquire ownership interests as tenants-in-common in certain computer equipment. The transaction is structured in a manner that is typical of many sale and leaseback transactions. [redacted] purchased computer equipment from [redacted] which was leased to an end-user. The equipment was then sold to [redacted]. which in turn sold the equipment to the owners. Simultaneous with the purchase of the equipment, [redacted] the equipment to [redacted]. The owners entered into a lease agreement with [redacted] for a term of [redacted] months. The equipment was "net leased" whereby the owners provided no service to the lessees.

[redacted] purchased the equipment for cash and a mortgage note. The owners' interests in the equipment are not transferable except upon written consent of [redacted] prior to any transfer. A transferee may become a substitute

owner at the sole and absolute discretion of [redacted].

Each owner is purportedly liable for his pro rata share of the mortgage note. If the owners do not derive sufficient income from the lease agreement to pay the mortgage note, [redacted] has the right to collect the mortgage note directly from the owners with each being liable for his pro rata share thereof not to exceed $[redacted] per ownership interest. Except for the obligations of the owners to the seller in connection with the purchase of the equipment, any owner who is required to pay more than his pro rata share of liabilities has a right of contribution against the other owners.

In addition, the owners entered into a management agreement with [redacted]. which will provide them with certain specified services such as arranging financing, collecting rent, distributing rent, meeting cash flow projections, remarketing the equipment and collecting items of income, profits, expenses and losses on a pro rata basis. Finally, each owner shares income and losses on a pro rata basis.

With respect to the remarketing of the equipment, [redacted] is required to remarket the equipment in a manner which is reasonably acceptable to the owners. In determining whether a proposed remarketing arrangement is acceptable to the owners, the owners have agreed that if any sublessee or proposed buyer is creditworthy and the price is not below the fair market value of the equipment, then the proposed remarketing arrangement is deemed to be acceptable.

II. [redacted]

The trust was created for the purpose of holding title to certain computer equipment on behalf of the investors. The stated purpose of an investment in the trust is to increase each investor's investment through amortization of the equipment notes, provide each investor with cash distributions upon the release or sale of the equipment at the end of the equipment lease and provide each investor with certain tax benefits during the early years of the equipment lease.

The structure of the transaction is essentially the same as the transaction involving [redacted]. [redacted]. [redacted] acquired computer equipment from [redacted]. At the time of the acquisition, the equipment was leased to an end-user. The equipment was simultaneously leased back to [redacted]. [redacted] then sold the equipment to a middle entity known an [redacted]. The trust purchased the equipment from [redacted]. for cash, a recourse note and a

nonrecourse note. The trust used recourse investor notes to make the downpayment.

The investors engaged an administrator to perform administrative services on their behalf including arranging for the execution of all documents in connection with the purchase of the equipment and in connection with the trust, issuing annual reports to investors for tax purposes, providing such statements as may be required by state law, and performing such other services of managerial or supervisory nature as is necessary in connection with the purchase, lease and operation of the equipment.

In addition, each investor is personally liable for up to $[redacted] per unit purchased. In order to transfer a unit, an investor must receive unanimous consent of all of the investors. The investor must pay any outstanding principal of any individual promissory note executed. The transferee must agree to assume the transferor's liability on the notes secured to purchase the equipment. Finally, the investors will share profits and losses on a pro rata basis.

III. [redacted]

The facts pertaining to this promotion are the same as those of the [redacted].

DISCUSSION

I. Partnership Classification

Section 7701(a)(2) defines a partnership as a "syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not . . . a corporation or a trust or estate." The classification under local law is not dispositive, since the Internal Revenue Code prescribes its own standards for qualification of an unincorporated association as a partnership and supercedes local law.1/ Luna v. Commissioner, 42 T.C. 1067, 1077 (1964) (citing Beck Chemical Equipment Corp. v. Commissioner, 27 T.C. 840 (1957)).

1/ Although state law is relevant to our inquiry, federal law overrides. The Internal Revenue Code sets the criteria to apply in classifying an organization for purposes of the federal income tax. Estate of Kahn v. Commissioner, 499 F.2d 1186 (2nd Cir. 1974), aff'g, T.C. Memo 1972-240; Luna v. Commissioner, 42 T.C. 1067, 1077 (1964); Treas. Reg. § 301.7701-1(c). Local law is relevant, however, to ascertain whether legal relationships exist which satisfy the federal criteria. Treas. Reg. § 301.7701-1(c).

In Commissioner v. Culbertson, 337 U.S. 733 (1949), the Court announced that a partnership exists for federal income tax purposes under the following circumstances:

> [C]onsidering all the facts-the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of the disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent-the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Id. at 742. In accordance with Culbertson, the intent of the parties to an investment is a key factor in determining whether a tax shelter promotion should be classified as a partnership for federal tax purposes. The Culbertson decision does not require the parties to intend to enter into a partnership, but rather the requisite intention must be to carry on a trade or business for joint economic gain.2/ The parties' intention in this respect is a question of fact. Commissioner v. Tower, 327 U.S. 280, 287 (1946).

In addition to the requirement that the parties must have intended to conduct a trade or business for joint economic gain, the following factors should be considered in determining whether a promotion should be classified as a partnership:

> The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal

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2/ That the owners expressed an intent not to be treated as partners for federal tax purposes is of little consequence. Individuals may constitute a partnership for tax purposes even though they expressly disclaim any intention to enter into a partnership relation. Baughn v. Commissioner, T.C. Memo 1969-282.

> partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964).

In general, a partnership is "created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses." Tower, 327 U.S. at 286. The Regulations provide that "[a] joint undertaking merely to share expenses is not a partnership." Treas. Reg. § 1.761-1(a); Temp. Treas. Reg. § 301.7701-3(a). The parties to the venture must contemplate the sharing of profits. Moreover, Temp. Treas. Reg. § 301.7701-3(a) states the following:

> Mere co-ownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a partnership thereby. Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.

The regulation indicates that there exists an important distinction between mere co-owners and co-owners who are engaged in a partnership. In general, the distinction between mere co-owners and co-owners who are engaged in a partnership is dependent upon the degree of business activity of the co-owners or their agents. Powell v. Commissioner, T.C. Memo 1967-32. Accord Madison Gas & Electric Co. v. Commissioner, 633 F.2d 512 (7th Cir. 1980).

In Powell, the Tax Court found that no partnership existed based on the aforementioned Regulations. The co-owners had inherited real property from their mother and reported rental income from this property on a partnership return. The Tax Court concluded that the filing of the partnership return did not establish the existence of a partnership. In Powell, the only activities of the co-owners or their agents were the payment of an insurance premium and commissions, the making of certain repairs and the hiring of an exterminator. Because the "degree

of business activity of the coowners" was minimal, the Court determined that no partnership existed. Powell, supra, at 164.

In Christian v. Commissioner, Docket No. 23453-86 (Memorandum Sur Order Feb. 17, 1988), petitioners had entered into a master recording lease with terms comparable to the ones in the present case. Petitioners argued that they had invested in a tenancy-in-common, requiring tax determinations to be made at the individual investor level. Respondent contended the petitioners had invested in a partnership and that a partnership audit must be conducted before a petition may be filed in the Tax Court. The Tax Court concluded that the entity should be treated as a partnership for federal income tax purposes.

Similarly, in Cokes v. Commissioner, 91 T.C. 200 (1988), the Tax Court found that a petitioner was a member of a partnership or joint venture taxable as a partnership where she was the owner of a working interest in seven leases to extract oil from certain real property, even though as an individual member of the group she was not active in the conduct of such trade or business and even though she lacked control over the operation of the business.

A. [redacted]

To determine whether the trusts should be classified as associations taxable as corporations or partnerships for, we must analyze section 7701 and the Regulations thereunder. Section 7701(a)(3) provides that "[t]he term 'corporation' includes associations, joint stock companies, and insurance companies." The Supreme Court fleshed out the meaning of section 7701(a)(3) in Morrissey v. Commissioner, 296 U.S. 344 (1935), and its companion cases, Swanson v. Commissioner, 296 U.S. 362 (1935), Helvering v. Combs, 296 U.S. 365 (1935), and Helvering v. Coleman-Gilbert, 296 U.S. 369 (1935). Treas. Reg. § 301.7701-1 through -4 reflect the Supreme Court's analysis and expand thereon.

An association is a type of unincorporated organization that is taxed as a corporation. If an organization has more corporate characteristics than non-corporate characteristics, it will be classified as an association taxable as a corporation for federal tax purposes, even if it is not incorporated under local law. Morrissey, supra; Treas. Reg. § 301.7701-2(a)(3). Corporations ordinarily have the following six characteristics:

1. associates;

2. an objective to carry on business and divide the gains therefrom;

3. continuity of life;

4. centralization of management;

5. liability for corporate debts limited to corporate property; and

6. free transferability of interests.

Treas. Reg. § 301.7701-2(a)(1).

To determine whether an organization more closely resembles a corporation than a trust or partnership, characteristics shared by both types of organizations must be ignored. Treas. Reg. § 301.7701-2(a)(3). Thus, since continuity of life, centralization of management, free transferability of interests, and limited liability are common to trusts and corporations, the determination of whether an organization which has these characteristics more closely resembles a corporation than a trust will generally depend on whether the organization has associates and a business objective. Morrissey, supra; Treas. Reg. § 301.7701-2(a)(2). Since associates and a business objective are common to partnerships and corporations, the determination of whether an organization which has these characteristics more closely resembles a corporation than a partnership will depend on whether the organization has continuity of life, centralization of management, free transferability of interests and limited liability. Treas. Reg. § 301.7701-2(a)(2).

Again, organizations which federal tax law would classify as partnerships and corporations share the characteristics of associates and a business purpose. At least one of these two characteristics is absent in organizations which federal tax law would classify as a trust. Therefore, an organization which has associates and a business purpose will be taxable either as a partnership or as a corporation under federal tax law. To determine the federal tax classification of [redacted] and [redacted], we must first determine whether the organization has associates and a business purpose. If the [redacted] and [redacted] do not possess both of these characteristics, then they will be taxable as trusts. If, however, [redacted] and [redacted] possess associates and a business purpose, then in order to determine whether the organizations will be treated as a partnership or as a corporation, the Service examines the remaining four corporate characteristics (continuity and life, centralization of management, free transferability of interests and limited liability). If the organization possesses a majority of the remaining four characteristics, then it is taxable as a corporation. Treas. Reg. § 301.7701-2(a)(3).

1. Associates

The beneficiaries of [redacted] voluntarily associated themselves by buying units of beneficial interest. Where trust beneficiaries do not freely associate together to form the trust (as in the case of the typical testamentary or inter vivos trust in which the beneficiaries are involuntarily associated together by the grantor), associate status within the scope of Morrissey and Treas. Reg. § 301.7701-2 depends on whether or not the beneficiaries's interests are freely transferable and whether the beneficiaries have any control over the trust's management. Where, however, trust beneficiaries voluntarily associate to form the trust, the beneficiaries are associates. Morrissey, supra, at 356-57. Thus, since the beneficiaries of [redacted] and [redacted] voluntarily associated themselves by buying units of beneficial interest, the beneficiaries are associates.

2. An Objective to Carry on Business and Divide the Gains Therefrom

A trust has a business objective where the trust instrument provides the authority to engage in business activity, regardless of whether or not the trust actually conducts business. Helvering v. Coleman-Gilbert Associates, 296 U.S. 369, 373-74 (1935). The trust agreements of [redacted] and [redacted] provide that the trusts were created for the purposes of acquiring certain equipment and leasing such equipment to the lessee. Arguably, these trust agreements provide the authority to engage in all activities necessary to exploit the equipment lease commercially. Thus, [redacted] and [redacted] have a business objective.

The division of authority between the trustee and the administrator has no effect on this analysis. Compare Commissioner v. Chase National Bank of the City of New York, 122 F.2d 540 (2d Cir. 1941) (Trust instrument divided authority between depositor and trustee, with trustee receiving nominal powers and depositor operating investment trusts. Because trustee and depositor had no powers beyond those necessary to the preservation of the trusts's res, the trusts had no business purpose.) with Commissioner v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941) (Trust instrument divided authority between depositor and trustee, with trustee receiving nominal powers and depositor operating investment trusts. Because depositor had discretionary power to vary investments, the trusts had a business purpose.)

Because [redacted] and [redacted] have associates and a business purpose, the organizations are not taxable as trusts. To determine whether [redacted] and [redacted] are taxable as corporations or whether, instead, they are taxable as

partnerships, we must examine the remaining four corporate characteristics.

> A state law trust may be characterized as a partnership for tax purposes if it actively carries on a financial or business venture for profit and it lacks at least two of the association characteristics of continuity of life, centralized management, limited liability and free transferability of interest. If, on the other hand, a trust which actively carries on a financial or business venture possesses three or more of these corporate characteristics, it is treated for tax purposes as an association (citations omitted).

McKee, Nelson & Whitmire, § 3.09 at 3-70.

3. Continuity of Life

With respect to the association characteristic continuity of life, the offerings of both trusts indicate the presence of this characteristic. The offerings of these trusts establish that they will terminate upon the earliest to occur of:

1. the inability of the Trustee to acquire the equipment;

2. the liquidation and final distribution to the Investors of the Trust Estate pursuant to the terms of the trust;

3. the revocation of the trust by unanimous written consent of the investors;

4. the effective date of the removal or resignation of the Trustee if no successor is appointed; and

5. December 31, 1993.

The Regulations provide that an organization does not lack continuity of life merely because it is to continue for a stated period if no member has the power to dissolve the organization. Temp. Treas. Reg. § 301.7701-2(b)(3). An organization lacks continuity of life where the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member causes a dissolution. Temp. Treas. Reg. § 301.7701-2(b)(1). Accordingly, the trusts in this case have continuity of life since a dissolution does not occur upon a change in the relationship between the investors notwithstanding the fact that the trusts will continue for a stated period.

4. Centralization of Management

Similarly, centralization of management seems to be present in both trusts. Centralized management exists where any person or group of persons has exclusive authority to make management decisions on behalf of the organization. Temp. Treas. Reg. § 301.7701-2(c). The declarations of trust do not vest the trustee with authority to make decisions or exercise business discretion with respect to the equipment leasing business except at the unanimous instruction of the owners. The authority of the owners to make certain decisions was delegated to the administrator. The trustee must rely on the administrator's instruction concerning actions requiring the unanimous consent of the owners. In addition, the administrator has the authority to determine, in its sole discretion, on what terms to attempt to re-lease or sell the equipment at the expiration of the lease. Accordingly, the administrator is vested with the management functions and, therefore, centralized management does exist in [redacted] and [redacted].

5. Free Transferability of Interests

The third characteristic which must be analyzed is free transferability of interest.

> An organization has the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization (emphasis added).

Temp. Treas. Reg. § 301.7701-2(e)(1). With respect to the trusts in this case, in order to transfer a unit, an investor must receive unanimous consent of all of the investors. As a result of this restriction on transfer, the trusts lack the association characteristic of free transferability of interest.

6. Limited Liability

The question of whether the trusts should be classified as partnerships, therefore, depends on whether the trusts have the association characteristic of limited liability. Limited liability exists where no member is personally liable for the debts of or the claims against the organization. Personal liability means that a creditor may satisfy a claim from a member of the organization to the extent that the assets of the organization are insufficient. Temp. Treas. Reg. § 301.7701-2(d)(1). Under the terms of both trusts, each investor is personally liable for payment of his pro rata portion of the recourse note. In addition, the investors are liable for payment of the recourse note even if the lessee defaults under its

obligation to pay rent under the equipment lease. Moreover, the offering provides the following:

> The Investors will be personally liable for all of the obligations of the Trust; therefore, the Investors will primarily bear the risk of loss, or damage to, the Equipment, subject to such exceptions as may be stated in the Equipment Lease, including certain indemnification provisions. The Investors may also be subject to such liability for injury to persons or property caused by such use and loss of profits, income or other amounts by reason of the Equipment's malfunction.

Accordingly, the trusts do not have the association characteristic of limited liability.

Because the trusts lack at least two of the association characteristics, the leasing equipment program should be classified as partnerships. The Regulations are clear that the fact that an organization is "technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if, applying the principles set forth in §§ 301.7701-2 and 301.7701-3, the organization more nearly resembles an association or a partnership than a trust." Temp. Treas. Reg. § 301.7701-4(b).

B. [redacted]

In the promotion involving [redacted], the facts and circumstances indicate that the co-ownership should be classified as a partnership. Although this determination is not clear-cut, we believe that the facts and circumstances provide a supportable basis for this conclusion. The owners, pursuant to the terms of the agreement, joined with other individuals to lease the rights to the computer equipment. They intended to join together to carry on a trade or business and contributed the property in furtherance of this trade or business. In addition, the owners have a community of interest in the computer equipment program because each was to profit or lose based upon his percentage share of the lease, re-leasing proceeds and remarketing proceeds.

In addition, there is a strong argument that a partnership is formed where the owners waive their rights to partition the property, even if they do not engage in any activity with respect to their property. This conclusion is based upon the following interpretation of Treas. Reg. § 1.761-2(a)(2):

> The conclusion that a partnership results when co-tenants surrender their rights to separately take and

> sell their interests in the property is buttressed by Regulation § 1.761-2(a)(2), which permits co-owners of investment property who do not actively conduct business to elect not to be subject to Subchapter K, provided they reserve the right separately to take and dispose of their shares of the property. The negative implication of the Regulation is that co-owners of investment property who do surrender their separate rights with respect to the property are partners, irretrievably.

McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners, § 3.03[5] at 3-24 (1977). In this case, the equipment was "net leased" to the end users. However, the owners entered into an agreement with [redacted] which provides that their interests in the equipment are not transferable except upon written consent of [redacted] prior to any transfer. Moreover, the agreement provides that a transferee may become a substitute owner at the sole and absolute discretion of [redacted]. We believe that this restriction on the free transferability of an interest is comparable to the owners waiving their rights to partition and supports the conclusion that the co-ownership should be classified as a partnership.

Moreover, in applying the associate characteristics of Treas. Reg. § 301.7701-2(a)(2), we conclude that [redacted] should be classified as a partnership and not as a corporation. As noted above, the determination of whether an organization more closely resembles a corporation than a partnership depends on whether the organization has continuity of life, centralization of management, liability for corporate debts limited to corporate property, and free transferability of interests. If [redacted] possesses a majority (three) of the corporate characteristics uncommon to partnerships, then it will be taxable as a corporation. See Rev. Rul. 64-220, 1964-1 C.B. 335.

1. Continuity of Life

The offering does not indicate that the death, insanity, bankruptcy, retirement, resignation of any member would immediately terminate the agreement. Accordingly, [redacted] has continuity of life since a dissolution does not occur upon a change in the relationship between the owners.

2. Centralization of Management

The owners agreed to hire a manager, [redacted], [redacted]., for the day to day management and operation of the equipment leasing business. The manager has the exclusive authority to make independent business decisions on behalf of the

organization. The manager has the authority to arrange financing, collect rent, distribute rent, meet cash flow projections and collect items of income, profits, expenses and losses on a pro rata basis. Accordingly, because the manager is vested with the management functions, centralization of management does exist in [redacted].

3. Liability for Corporate Debts Limited to Corporate Property

The agreement provides that each owner is liable for his pro rata share of the mortgage note. If the owners do not derive sufficient income from the lease agreement to pay the mortgage note, [redacted] has the right to collect the mortgage note directly from the owners with each being liable for his pro rate share thereof not to exceed $[redacted] per ownership interest.

In addition, the agreement provides that each owner is liable for the obligations of the owners, including, but not limited to, certain obligations of the owners to the seller in connection with the purchase of the equipment. Finally, the agreement provides that each owner will have liability with respect to any personal liability claims or property damage claims arising out of the use of the equipment. Accordingly, [redacted] does not have the association characteristic of limited liability.

4. Free Transferability of Interest

The [redacted] agreement provides that an owner's interest in the equipment is not transferable except upon written consent of [redacted] prior to any transfer. A transferee may become a substitute owner at the sole and absolute discretion of [redacted]. Because [redacted] has the sole and absolute discretion to withhold consent, we conclude that [redacted] lacks free transferability of interest.

Therefore, since [redacted] appears to lack at least two out of the four distinguishing corporate characteristics, the equipment leasing business is not an association taxable as a corporation but, rather, is a partnership for federal tax purposes.

II. The Filing of a Substitute Return

In the present case, it is our position that the tax shelter promotions [redacted], [redacted] and [redacted] are TEFRA partnerships subject to the provisions of I.R.C.§§ 6221 through 6233. Pursuant to these provisions, the tax treatment of items of partnership income, loss, deductions and credits is

determined at the partnership level in a unified partnership proceeding. In proceeding with a partnership level audit, the Service should prepare substitute or "dummy" partnership returns for the partnerships in accordance with section 6020(b)(1). Section 6020(b)(1) provides that:

> If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise.

This substitute return prepared by the Service will not be treated as a return of the partnership. I.R.C. §§ 6229(c)(4).3/ Therefore, because no valid [redacted] partnership return will be filed by the entities, any tax that is attributable to a partnership item may be assessed at any time. I.R.C. § 6229(c)(3).

The Service will have to issue a Notice of Beginning of Administrative Proceedings as required by section 6223. In addition, once the partnership level audit is complete, the Service is required by section 6223(a) to issue a Notice of Final Partnership Administrative Adjustment ("FPAA"). This FPAA should show zero as being the amount reported for each partnership item being adjusted since no partnership return was ever filed.

It is Service position that after initial classification, if it is subsequently determined that the partnership audit provisions are incorrectly being used, or vice versa, the correct procedures should be initiated whenever possible. Because the three entities should be classified as partnerships, the Service should not issue statutory notices of deficiency to the investors. The normal deficiency procedures do not apply to TEFRA partnerships. Partnership item adjustments are included in the FPAA rather than a statutory notice of deficiency. Any statutory notice which purports to determine a deficiency for TEFRA partnership items other than through procedures prescribed by sections 6221 through 6233 is invalid to the extent of partnership and affected item adjustments. Maxwell v. Commissioner, 87 T.C. 783 (1986); Farris v. Commissioner, T.C. Memo 1986-567.

3/ The only real purpose for preparing the substitute partnership return is to create a tax module for the Examination function to further process the partnership level audit.

If an invalid statutory notice of deficiency containing partnership item adjustments is issued and the taxpayer files a petition in the Tax Court, we recommend filing a motion to dismiss for lack of jurisdiction. If a statutory notice of deficiency contains TEFRA partnership items as well as nonpartnership items, a motion to dismiss for lack of jurisdiction and to strike would be necessary. Such motion should be limited to that portion of the statutory notice and pleadings pertaining to partnership and affected item adjustments to preserve the validity of the statutory notice with respect to the nonpartnership items. See Sparks v. Commissioner, 87 T.C. 1279 (1986). Accordingly, with respect to the individual investor who was issued a notice of deficiency for adjustments relating to his investment in the computer leasing investment, the Service should file a motion to dismiss for lack of jurisdiction.

III. The Treatment of Similar Tax Shelter Promotions

As noted above, whether a tax shelter vehicle should be classified as a partnership is a question of fact to be determined by looking at the individual facts and circumstances of the tax shelter. As a result, we cannot articulate a uniform position as to whether similar tax shelter vehicles should be classified as partnerships.

Finally, we have been informed by George Soba of the Brooklyn District Counsel office that he was assigned one of the cases in the promotions discussed in this tax litigation memorandum. He has raised the same issues with respect to that case as are raised by your request. We have, therefore, provided him with a copy of this memorandum.

If you have any questions regarding this matter, please contact Vada Waters at (FTS) 566-3289.

CURTIS G. WILSON

cc: George Soba