OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL,

FROM: Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: NOL carryforward claims of partnership items

This Field Service Advice responds to your memorandum dated December 7, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Representatives:

X =

Y =

PS =

SC =

YR1 =
YR2 =
YR3 =
YR4 =
YR5 =
YR6 =
YR7 =

ISSUES

1. Whether the statute of limitations is open for the Tax Court to consider a partner's request for adjustments to the characterization of losses reported by a partnership for other tax years in determining the partner's tax liability for the year to which the losses might be carried forward.

2. Whether the statute of limitations is open for the Tax Court to consider a shareholder's request for adjustments to the characterization of losses by an S corporation for other tax years in determining a shareholder's tax liability for the year to which the losses might be carried forward.

CONCLUSIONS

1. Because PS, a partnership, is subject to the TEFRA unified audit provisions for the years in which it reported the losses that a partner wants to recharacterize and carry over to the tax year pending before the Tax Court, the Tax Court does not have jurisdiction in the partner's pending case to consider the characterization of the partnership's losses; the characterization of the losses is a partnership item that can only be determined in a unified partnership proceeding. The partner did not initiate a timely action for the recharacterization of the partnership's losses under the TEFRA unified audit provisions.

2. Because SC, an S corporation, is not subject to the unified audit proceedings for S corporations, section 6214(b) gives the Tax Court jurisdiction to consider the characterization of the S corporation's losses in a shareholder's Tax Court case if the limitations period is open for the year before the court, even if the statute of limitations has expired for the year (or years) in which the losses were incurred.

FACTS

X and Y, husband and wife, are the petitioners in a pending Tax Court case based upon a notice of deficiency proposing an additional joint income tax liability for YR7. Although X and Y are prepared to settle the issue raised in the notice of deficiency,

X and Y have claimed an overpayment of taxes for YR7 based upon the carryforward of net operating losses from YR1 through YR6. YR1 through YR6 are calendar years beginning after September 3, 1982, but before January 1, 1997.[1] PS and SC are, respectively, a partnership and a subchapter S corporation that have operated over a period of tax years ending December 31 and including YR1 through YR6. X is a general partner and the tax matters partner of PS; the only other partner in PS is a trust controlled by X. X is the sole shareholder in SC.

The operating losses were allegedly incurred by X, by PS, and by SC in trading options, forwards, futures, and swap contracts during YR1 through YR6. X, PS, and SC all reported the losses as capital losses, either short-term or long-term, under Code sections 1201 through 1256 on the returns that X, PS, and SC filed for YR1 through YR6. X and Y now claim that X, PS, and SC incurred ordinary losses in YR1 through YR6 because either --- 1) X, PS and SC were active traders or dealers in this trading activity rather than investors, or 2) the trades were section 988 transactions. The Service had not examined the trading activities before the issues were raised by X and Y in the Tax Court case for the YR7.

For YR1 through YR6, PS filed Forms 1065, U.S. Partnership Returns of Income, on which it reported net short term capital gains or losses and net long term capital gains or losses from the trading activity. On a Schedule K-1 for each year, PS reported the portion of the net gains or losses that was allocable to X. For each year in which PS reported net short-term gains or losses and net long term capital gains or losses, X and Y reported the information from the Schedule K-1 on their annual income tax return.

For YR1 through YR6, SC filed Forms 1120S, U.S. Income Tax Returns for an S Corporation, on which it reported net short term capital gains or losses and net long-term capital gains or losses from the trading activity. Alternatively, SC reported section 1256 income or losses that are statutorily allocated between short term and long term gains and losses. SC's returns were due after January 31, 1987.[2] On a Schedule K-1 for each year, SC reported 100% of the net gains or

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[1] Partnership years beginning after September 3, 1982, are subject to the unified audit procedures for partnerships under Code sections 6221 through 6233. The tax years of S corporations beginning between September 3, 1982 and January 1, 1997 are subject to the unified audit procedures for S corporations under sections 6241 through 6245. See Law and Analysis section of this memorandum.

[2] Treas. Reg. § 301.6241-1T(c)(2)(ii), which applies to tax years of S corporations for which returns are due after January 30, 1987, generally excepts S corporations with five or fewer shareholders, all of whom are natural persons or estates, from the unified audit procedures, unless the S corporation elected to be included.

losses as being allocable to X. For each year in which SC reported net short-term and long-term capital losses, X and Y reported the information from the Schedule K-1 on their annual income tax return.

The Service has not audited the income tax returns filed by X and Y, the partnership returns filed by PS, or the S Corporation returns filed by SC for YR1 through YR6. Neither X nor his partner in PS have filed a request for administrative adjustment for PS, and X has not filed a request for administrative adjustment for SC. We are aware of no claims for refund filed by X and Y for Y1 through YR6. The general three year period in which the Service can assess tax against X and Y as well as the three year period (or two year period) in which X and Y can file a claim for refund for YR1 through YR6 have expired. The period for filing a request for administrative adjustment for the YR1 through YR6 tax years of PS and SC has also expired.

LAW AND ANALYSIS

1. The Tax Court lacks jurisdiction over partnership items in a deficiency case.

X and Y have made overpayment claims in this case for YR7 based upon their effort to recharacterize trading losses separately incurred by X, by PS, and by SC in YR1 through YR6 as ordinary losses, rather than capital losses. They claim that X's ordinary losses in YR1 through YR6 can be carried over to YR7. Likewise, because the losses incurred by PS and SC in each year flow through to X (as, respectively, a partner and a shareholder), X and Y contend that the recharacterization of the PS and SC losses would also give rise to net operating losses that X and Y could carry over to YR7. We separately consider the losses incurred and reported by X, by PS, and by SC.

A. In determining a tax deficiency or overpayment, the Tax Court can consider losses incurred by the taxpayer in another tax year.

X and Y are able to raise the characterization of the losses that X incurred in YR1 through YR6 in the Tax Court case for the determination of a deficiency or an overpayment for YR7 under Code § 6214(b), even though the earlier years are not before the court and even though the limitations periods for assessing tax or claiming refunds for those years have expired. In determining X and Y's YR7 tax liability, including overpayments, the court clearly has jurisdiction to consider transactions in other years that affect the YR7 taxes. Section 6214(b) gives the Tax Court jurisdiction —

> to consider such facts with relation to other years and other quarters as may be necessary correctly to redetermine the amount of [the deficiency for the year before the court], but in so doing shall have no

> jurisdiction to determine whether or not the tax for any other year has been overpaid or underpaid.

The Tax Court has previously held that the court may consider whether the taxpayer actually incurred the loss as claimed or would have exhausted the loss by using it in years other than the year before the court when a taxpayer claims the benefits of the carryover of a net operating loss to the year before the court. Leitgen v. Commissioner, 82-2 U.S.T.C. ¶ 9553 (8th Cir. 1982), aff'g T.C. Memo. 1981-525 (1981) (Substantiation of claimed 1972 NOL was considered in determining whether loss was available to be carried forward to 1973, 1974 and 1975); Phoenix Coal Co. v. Commissioner, 231 F.2d 420 (2d Cir. 1956), aff'g T.C. Memo. 1955-28 (1955) (Adjustments to income in 1945 were considered in determining how much of 1947 NOL was available for use in 1946); Lone Manor Farms, Inc. v. Commissioner, 61 T.C. 436, 440 (1974), aff'd without published op., 510 F.2d 970 (3d Cir. 1975) (NOLs available for use in 1967 could not be used in 1969); and ABKCO Industries, Inc. v. Commissioner, 56 T.C. 1083 (1971), aff'd on other grounds, 482 F.2d 150 (3d Cir. 1973) (Commissioner could recompute income for closed short taxable year to determine how much of carried back NOL was available in a succeeding year).

Likewise, the Tax Court may consider the characterization of losses directly incurred by a taxpayer in one year as either ordinary or capital losses for the purposes of determining the taxpayer's NOL carryback from the transaction in another year. See Furor v. Commissioner, 74 A.F.T.R.2d ¶ 6019, (9th Cir. 1994); aff'g T.C. Memo. 1993-165 (Losses from the 1987 stock market crash were found to be capital losses, rather than ordinary losses giving rise to NOLs that could be carried back to 1985 and 1986 (the years before the court)). See also Chamberlin v. Commissioner, T.C. Memo. 2000-50, in which the Tax Court considered whether to characterize a loss as resulting from a business bad debt (ordinary loss) or a nonbusiness bad debt (short term capital loss) before determining that none of the loss could be carried to the years at issue before the court.

We have no doubt that the Tax Court has jurisdiction to consider the characterization of the losses claimed by X and Y on their YR1 through YR6 income tax returns which respect to X's trading activities in determining any tax deficiency or overpayment for YR7.

B. In determining a tax deficiency or overpayment for X and Y, the Tax Court does not have jurisdiction to consider the recharacterization of the capital losses reported by PS, a TEFRA partnership.

The overpayment claims with respect to trades by PS in YR1 through YR6 involve not only the carryover of losses from tax years not before the court, but the redetermination of the character of losses incurred and reported by the partnership.

Because PS reported the losses from its trading activity as capital losses on its partnership returns for YR1 through YR6, X and Y reported the flow through of these losses as capital losses on the income tax returns X and Y filed for YR1 through YR6. Under sections 6221 through 6233 of the Code, PS's characterization of its losses on its partnership returns as capital losses is a partnership item that can only be redetermined in a TEFRA partnership. See sections 6221 through 6233.

The partnership provisions in Title IV of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, sec. 401-407, 96 Stat. 324, 648-71, established a unified audit and litigation process under Code sections 6221 through 6233 for determining the tax treatment of partnership items at the partnership level. These provisions replaced the then existing process under which amounts reported by a partnership were audited and resolved separately for each partner in individual administrative and judicial proceedings. For partnership tax years beginning after September 3, 1982,[3] these TEFRA provisions created a statutory dichotomy between the procedures applicable to the determination of tax deficiencies and overpayments under sections 6211 through 6215 of the Code and the procedures applicable to the administrative adjustment and judicial readjustment of partnership items under section 6621 through 6233. Several cases contain a comprehensive description of the partnership audit process and the reasons for its adoption. See Addington v. Commissioner, __ F.3d __, (2d Cir., February 29, 2000), aff'g Sann v. Commissioner, T.C. Memo. 1997-259; Randell v. United States, 64 F.3d 101, 103 (2d Cir. 1995), cert. denied, 519 U.S. 815 (1996); and Maxwell v. Commissioner, 87 T.C. 783 (1986).

The TEFRA unified audit rules for partnerships apply to taxable years of partnerships, such as PS's YR1 through YR6, that began after September 3, 1982. The TEFRA rules, at section 6231(a)(1), exclude from the TEFRA process certain small partnerships that, by definition, have 10 or fewer partners -- each of whom is an individual, a subchapter C corporation, or the estate of a deceased partner. See section 6231(a)(1)(B)(i). Although there are only two partners in PS, PS does not qualify for the small partnership exception, since one of the two partners in PS is a trust. See Ivory v. United States, 96-1 U.S.T.C. ¶ 50078 (S.D. Ohio 1995) (assessment of tax based upon unified partnership audit was proper because partnership including trust did not qualify for small partnership exception).

In the interest of providing consistent treatment for all partners in a partnership, the TEFRA partnership provisions require adjustments to "partnership items" to be made at the partnership level in a separate TEFRA partnership proceeding. See section 6226. Section 6231(a)(3) defines a "partnership item" as any item that is

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[3] See fn. 1.

required to be taken into account for the partnership's taxable year under any provision of the Code to the extent that Service regulations provide that the item is more appropriately determined at the partnership level than at the partner level. N.C.F. Energy Partners v. Commissioner, 89 T.C. 741 (1987). The Service's regulations define partnership items to include "the partnership's aggregate and each partner's share of . . . [i]tems of income, gain, loss, deduction or credit of the partnership." Treas. Reg. § 301.6231(a)(3)-1(a)(1). They also include factors affecting the determination of partnership items. Treas. Reg. § 301.6231(a)(3)-1(b). Thus, the amount and character of gains and losses from a partnership's trading activities are partnership items that are to be determined in a partnership proceeding. See Regan v. Commissioner, T.C. Memo. 1993-623.

The statutory goal of the unified audit proceedings is found in section 6221, which provides that the tax treatment of partnership items "shall be determined at the partnership level." The partnership level adjustments must be finally resolved before the flow through TEFRA tax adjustments based upon the adjustments to partnership items can be made to partners' tax liabilities. See sections 6223, 6225, and 6226; White v. Commissioner, 95 T.C. 209, 211 (1990). The Tax Court has jurisdiction over partnership items only in those cases in which a timely petition for readjustment of partnership items has been filed with that court. See section 6226(a).

The Tax Court has no jurisdiction to redetermine any portion of a deficiency attributable to adjustments to partnership items when no FPAA has been issued by the Service. Trost v. Commissioner, 95 T.C. 560, 564 (1990); Roberts v. Commissioner, 94 T.C. 853, 859 (1990); Munro v. Commissioner, 92 T.C. 71, 73 (1989); and Maxwell v. Commissioner, 87 T.C. 783, 789 (1986). The Maxwell opinion clearly illustrates the rationale for the Tax Court's lack of jurisdiction in this case. Mr. Maxwell, one of the taxpayers in that case, formed VIMAS Ltd., a limited partnership in December 1982, with 13 limited partners and himself as the general partner. While a partnership audit of VIMAS for the 1982 tax year was pending, the Service issued a notice of deficiency to the Maxwells determining deficiencies and additions to the tax for the years 1979, 1980, 1981, and 1982. The proposed deficiencies for 1982 resulted in part from the disallowance of Mr. Maxwell's claimed distributive share of VIMAS' losses and investment tax credits for 1982. The 1979 and 1980 deficiencies were attributable to the Maxwells' claimed carryback of part of the disallowed investment tax credit to those years. The Service had not completed the VIMAS audit and had not issued an FPAA to the VIMAS partners when the notice of deficiency was issued.

As the parties were reaching a basis for settling the case, the Service reconsidered the notice of deficiency and concluded that the partnership's losses and investment tax credits were partnership items. The Service filed a motion to strike the partnership items and affected items from the petition for lack of jurisdiction on the

grounds that the Tax Court had no jurisdiction to consider them, unless they were raised in a TEFRA petition filed after an FPAA had been issued for the partnership. The court granted the motion. In explaining its lack of jurisdiction, the court analyzed the purpose underlying the TEFRA partnership audit process and raised several key points:

– The Service has no authority to assess a deficiency attributable to a partnership item until after the close of the partnership proceeding, (section 6225(a)), and may be enjoined from making premature assessments. Maxwell, at 788.

– All nonpartnership matters on a partner's income tax return continue to be subject to existing rules for administrative and judicial resolution of the partner's tax liability. Neither the Service nor the taxpayer are permitted to raise nonpartnership items in the course of a partnership proceeding nor may partnership items be raised in proceedings relating to nonpartnership items of a partner, unless the partnership items are converted to nonpartnership items. H. Rep. 97-760, 97th Cong., 2d Sess. at 611 (1982), 1982-2 C.B. 600 at 668; Maxwell, at 788.[4]

– Because section 6226 makes the issuance of an FPAA a condition precedent to the exercise of its jurisdiction over a partnership action, the Tax Court has no jurisdiction over partnership items until an FPAA is issued for the partnership. Maxwell, at 789.

– Losses and credits claimed by a partnership are "partnership items," unless some provision of the statute transmits them into "nonpartnership items." Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i) and (vi)(A). Maxwell, at 790.

– The existence or the amount of carrybacks of the investment tax credits or NOLs from the year in which the partnership claimed the credits or losses to other years are affected items, as defined in section 6231(a)(5), that are dependent upon the determination of a

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[4] None of the partnership items reported on the partnership returns filed by PS have been converted into nonpartnership items under section 6231: 1) the Service has not notified X that the items shall be treated as nonpartnership items; 2) X has not filed suit after the Service failed to allow an administrative adjustment request (since none was filed); 3) the Service has not entered into a settlement agreement with X; and 4) (because there have been no proceedings) the Service has not failed to provide timely notice of partnership proceedings to X.

> partnership item -- such as the amount of the partnership loss or the credit – and cannot be considered until the partnership item is resolved. Maxwell, at 790-91.

The Tax Court's analysis in Maxwell applies to prohibit the consideration of the partnership items in this case. The Tax Court cannot consider an adjustment to the character of the losses reported by a TEFRA partnership, a partnership item, until the Service issues an FPAA for the partnership. Further, the Tax Court may consider the partnership items only in a partnership proceeding, not in a deficiency proceeding, even if a FPAA has been issued. Trost v. Commissioner, 95 T.C. 560, 564 (1990) (partner could not reduce his liability for tax on nonpartnership items by using items attributable to a partnership) . If there have been no partnership proceedings in which an FPAA might be timely issued and there can no longer be a partnership proceeding under the normal statute of limitations, the only possible outcome of the partnership proceeding is the acceptance of the partnership return as filed. Roberts v. Commissioner, 94 T.C. 853, 860 (1990). In this case, where the Service has not issued, and is now time barred from issuing, an FPAA to question the amount, the characterization, or the allocation of the losses reported by PS for YR1 through YR6, the Tax Court does not have jurisdiction to consider changing the character or the amount of such losses, or the allocation of those losses among the PS partners.

The court's jurisdiction under section 6214(b) is limited to considering X and Y's use of the losses as reported by PS for YR1 through YR6. Like the carryback of losses and investment tax credits in Maxwell, the carryforward of X's share of the PS losses to YR7 by X and Y is an "affected item." See Bob Hamric Chevrolet, Inc. v. United States, 849 F.Supp. 500 (W.D. Tex 1994)(When a partnership loss, deduction or credit allocated to a partner in one year carries over or back to other years at the partner's level, such carryover or carryback is an affected item). An affected item is "any item to the extent such item is affected by a partnership item." See section 6231(a)(5); Harris v. Commissioner, 99 T.C. 121, 125 (1992). Unlike partnership items, "affected items" need not necessarily be determined in a partnership proceeding. Affected items may be either computational adjustments that cannot be made until the partnership proceeding is completed, or matters that require factual determinations to be made at the partner level. Section 6230(a)(1); Olson v. United States, 172 F.3d 1311 (Fed. Cir. 1999). Computational adjustments made upon the completion of the partnership proceedings that do not require separate partner level determinations may be summarily made once the partnership adjustment is final. Otherwise, once the partnership proceeding is completed, the Service must issue a notice of deficiency to a partner for additional deficiencies, before making any assessment that is attributable to an affected item requiring partner level determinations. Section 6230(a)(2)(A)(i); Olson, at 1317-18; Brookes v. Commissioner, 108 T.C. 1, 5-6 (1997); N.C.F. Energy Partners v. Commissioner, supra, at 744.

Because changes to affected items need not be determined in a partnership proceeding, the Tax Court has jurisdiction under section 6214(b) to consider the amount of any passed through partnership losses that can be carried back or carried forward to the year before the court by considering the taxpayer-partner's use of the loss in the year before the court and in other years. See Harris v. Commissioner, 99 T.C. 121 (1992). However, to the extent that the existence and amount of a net operating loss carryback or carryforward that is available in a given year rests upon the existence and amount of a partnership item, i.e., the loss reported by the partnership, the Tax Court cannot consider changes in the amount of the partnership loss. See Harris v. Commissioner, 99 T.C. 121 (1992), in which the Tax Court held that section 6214(b) gave it jurisdiction to consider NOL carrybacks based upon a settled TEFRA case in a Rule 155 computation, but that it would not take into account pending claims for NOLs in a second pending partnership case or hold the record open in the deficiency case until the pending partnership case was completed. The court agreed with the Service's stated conditions as to when section 6214(b) would apply:

> the settled partnership items may not be redetermined in the instant proceeding, . . . the NOL carryback claim must be consistent with the partnership settlement, and . . . the carryback claim must be made in the applicable limitations period for claiming refunds.

Harris, at 127. Section 6214(b) gives the Tax Court jurisdiction to consider affected items based upon the outcome of a partnership action, but does not allow the court to consider adjustments to partnership items in a deficiency case. Inasmuch as the claim filed by X and Y would require the redetermination (now barred by the statute of limitations) of the partnership items reported by PS on its returns for YR1 through YR6, section 6214(b) does not authorize the Tax Court to consider those items in the pending deficiency proceeding.

Finally, the TEFRA provisions do not allow X and Y to change the treatment of the partnership items on their returns for YR1 through YR6 in this tax deficiency proceeding. Partners are responsible for consistently reporting partnership items under TEFRA. Unless a partner notifies the Service of an intent to depart from the reporting of items on a partnership return, the partner must report his or her share of partnership items consistently with the treatment of the item on the partnership return. See section 6222. If no notification is made, the Service may make a computational adjustment to conform the partner's return to the partnership return. Temp Treas. Reg. § 301.6222(b)-2(a)T. To change the treatment of a partnership item on a partner's return, as X has sought to do in this case, a partner must file a request for administrative adjustment (RAA) as required by section 6227. The RAA may be filed no later than the early of: (1) three years after the later of the filing date or due date of the partnership return for the taxable year to which the request relates, or (2) the date on which an FPAA is mailed to the tax matters partner with

respect to the taxable year. For the partnership years YR1 through YR6, X did not file a timely RAA and no FPAA was issued. For the purposes of determining the carryover of losses to YR7, the partners in PS are bound by the amount and character of the losses reported on PS's returns for YR1 through YR6. See Maxwell v. Commissioner, 87 T.C. 783, 789 (1986); Harris v. Commissioner, 99 T.C. 121 (1992); and Roberts v. Commissioner, 94 T.C. 853, 860 (1990).

2. The Tax Court has jurisdiction to consider the character of a S Corporation's losses that are subject to small corporation exception.

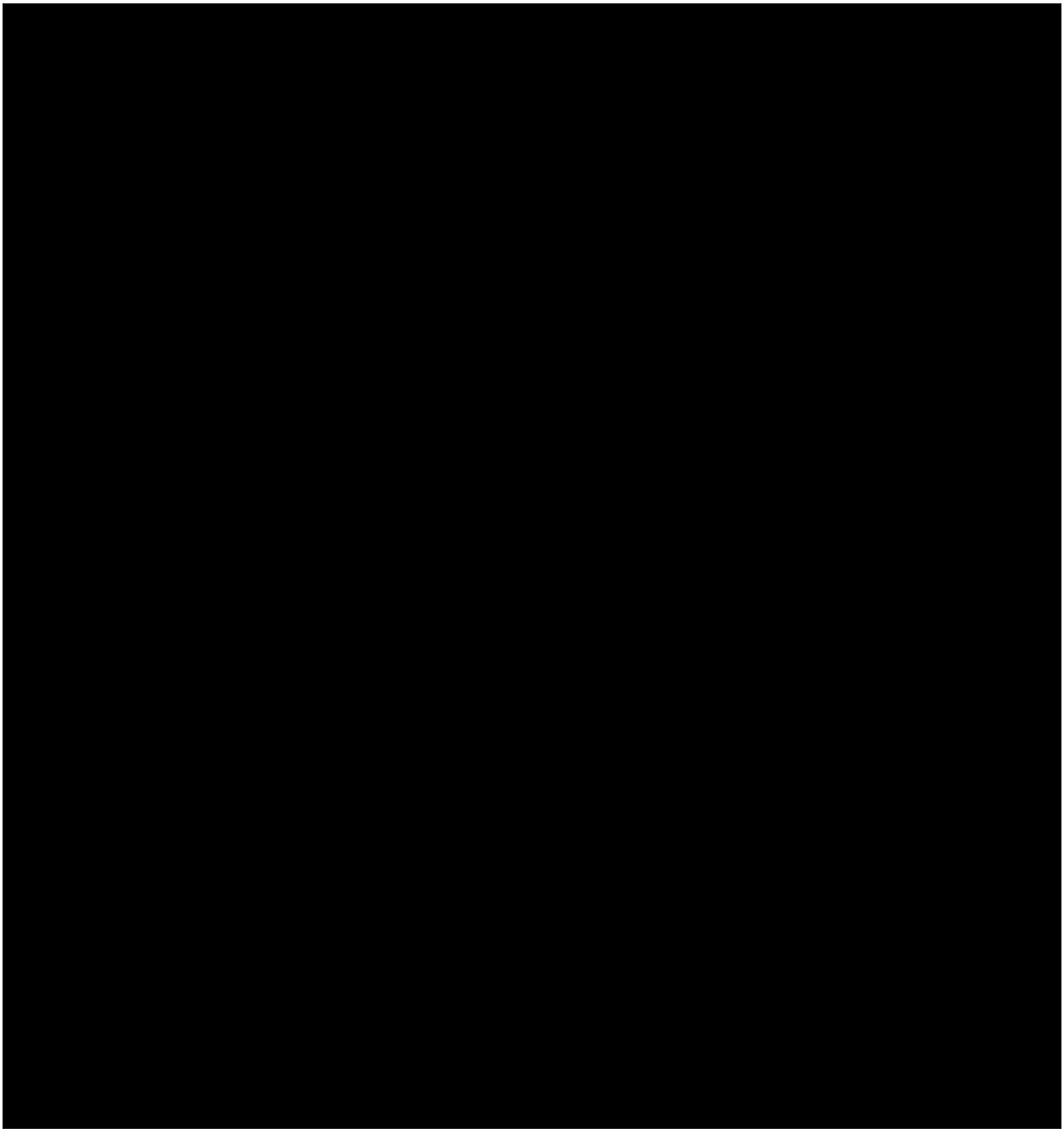
An S corporation, like a partnership, does not pay taxes as an entity, but files an information return reporting certain items (income, gain, losses, deductions, and credits) that are passed through to its shareholders for inclusion on their individual returns. See Beard v. United States, 992 F.2d 1516, 1519 (11th Cir. 1993). Under the Subchapter S Revision Act of 1982 (SSRA), Pub. L. 97-354, 96 Stat. 1669, codified in part at sections 6241 through 6245 of the Code, prior to repeal of these sections by the Small Business Job Protection Act of 1996, Pub. L. 104-188, 110 Stat. 1755 (1996), the unified TEFRA audit procedures apply to S corporations with tax years beginning after September 3, 1982 and before January 1, 1997. Dardanos Assoc./Third Dividend v. Commissioner, 88 F.3d 821, 823 (9th Cir. 1996). Shareholders in S corporations must treat S corporation items on their individual returns consistently with the returns filed by the S corporation. See section 6242. As with partnerships, if the Subchapter S audit procedures are applicable and unified corporate level proceedings are required, the Tax Court has no jurisdiction to determine, in a separate deficiency case, any part of a shareholder's tax deficiencies that are attributable to subchapter S items. See section 6214 and University Heights at Hamilton Corp. v. Commissioner, 97 T.C. 278, 280-81 (1991).

In Treas. Reg. § 301.6241-1T(c)(2)(ii), the Service exercised its authority to provide an exception from the unified audit procedures for small S corporations with returns due after January 30, 1987. The Service excepted S corporations with five or fewer shareholders, all of whom are natural persons or estates. Since X was the only shareholder in the YR1 through YR7, all years for which returns were due after January 30, 1987, the unified audit provisions for S corporations do not apply to SC. See Eastern States Casualty Agency, Inc. v. Commissioner, 96 T.C. 773 (1991) (regulation not effective for 1984 tax year); and Davis v. Commissioner, T.C. Memo. 1997-80 (exception does apply).

Since the unified audit procedures do not apply to SC, the normal deficiency procedures under sections 6211 through 6214 do apply. Under those rules, the Tax Court can consider any tax items that would otherwise be within its jurisdiction for YR1 through YR6 in determining the income tax liability of X and Y for YR7. Those items include the losses reported of SC's corporate return and passed

through to X to the same extent as the losses that have been reported directly by X and Y. See Reilly v. Commissioner, T.C. Memo. 1989-312 (For a pre-TEFRA year, section 6214(b) gave the court authority to redetermine the taxpayer's distributive share of a partnership's loss and investment tax credits).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call if you have any further questions.