DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: ASSOCIATE CHIEF COUNSEL CC:ITA

SUBJECT:

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LEGEND
Partnerships =

Opinion =

Property	=	
Year 1	=	
Year 2	=	
Year 3	=	
Year 4	=	
Year 5	=	
Date A	=	
Date B	=	

ISSUES

1. Whether the I.R.C. § 6659 addition to tax for understatements attributable to valuation overstatements (Year 1 and Year 2) or the I.R.C. § 6662 accuracy-related penalty for substantial valuation misstatements (Year 3, Year 4, and Year 5) can be asserted against the individual partners of the partnerships.

2. Whether the increased interest rate for substantial understatements attributable to tax motivated transactions, due to a basis overstatement, under I.R.C. § 6621(c) can be applied to the individual partners' liabilities for Year 1 and Year 2.

CONCLUSIONS

1. The I.R.C. § 6659 addition to tax for understatements attributable to valuation overstatements (Year 1 and Year 2) or the I.R.C. § 6662 accuracy-related penalty for substantial valuation misstatements (Year 3, Year 4, and Year 5) can be asserted against the individual partners of the partnerships.

2. The increased interest rate for substantial understatements attributable to tax motivated transactions, due to a basis overstatement, under I.R.C. § 6621(c) can be applied to the individual partners' liabilities for Year 1 and Year 2.

FACTS

On Date A, the Tax Court issued an opinion disallowing all deductions claimed by the partnerships for taxable years Year 1 through Year 5. On Date B, the Tax Court entered decisions, based on uncontested Rule 155 computations submitted by the Commissioner.

The decisions entered in each of the partnership cases reflects a total disallowance of all items of income, deduction, gain, loss, expense, credit, etc. reported by the partnerships for the tax periods involved. That is, every item reported on the Forms 1065, U.S. Partnership Return of Income, filed by the partnerships was "zeroed out", thereby eliminating the flow-through of such items to the individual partners.

Included among the disallowed deductions was a significant amount of depreciation expense claimed with respect to the partnership property.

In reaching these decisions, the court found that the partnerships had never acquired the benefits and burdens of ownership of the property. As the basis for its opinion, the court found that bills of sale presented by two of the partnerships listed large numbers of property that did not exist, that the partnerships' stated purchase prices did not reasonably approximate the fair market value of the property, and that the alleged recourse promissory notes the partnerships issued were not valid recourse indebtedness. As to the third partnership, the court found insufficient evidence that the partnership acquired property in the year claimed.

Based on the same findings, the court also held that the partnerships were not entitled to interest deductions and certain other deductions. Because the partnerships did not acquire the benefits and burdens of ownership of the property involved, the court rejected the Service's determination of capital gains or other farm income from the sale of the property.[1] The court further denied the partnerships' deductions for guaranteed payments to their general partner, finding insufficient evidence regarding the nature of the services performed by the partner and whether the payments represented reasonable compensation for those services.

In its findings on whether the partnerships were entitled to depreciation deductions with respect to the property, the court stated:

In its discussion of whether the partnerships’ stated purchase price reasonably approximated the property’s fair market value, the court stated:

.

[1] The Commissioner did not assert that each of the partnership’s transactions was a sham.

The court made further observations regarding the valuation of the property in its discussion of the validity of the partnerships' notes. As support for its conclusion that the partnership notes were not valid indebtedness, the court noted:

The court concluded its discussion of the partnerships' entitlement to depreciation deductions stating:

In summary, the court held that two of the partnerships did not acquire the benefits and burdens of ownership with respect to the property they had purportedly acquired and the other partnership had failed to offer sufficient evidence substantiating its alleged acquisition of property. Notwithstanding its determination that the partnerships' stated purchase price did not reasonably approximate the fair market value of the property, the court's opinion contains no specific determination of the amount of property acquired by each of the separate partnerships or a determination of the property's value. And, as indicated above, the entered decisions reflect a total disallowance of the depreciation deductions reported by the partnerships for the tax periods involved.

LAW AND ANALYSIS

Procedural Considerations

Under the TEFRA unified audit and litigation procedures, the tax treatment of items of partnership income, loss, deductions, and credits are determined at the partnership level in a unified partnership proceeding rather than separate proceedings with the partners. Section 6221. Once partnership determinations become final, the Service and the partners are bound by those determinations. Section 6230.

Once the partnership Decisions have become final, the Service will make computational adjustments to reflect changes in each partner's individual tax liabilities resulting from the partnership level adjustments. Section 6231(a)(6). The Service may assess the computational adjustment amounts against the partners without issuing a notice of deficiency. Section 6230(a); N.C.F. Energy Partners v. Commissioner, 89 T.C. 741, 745 (1987).

A partnership item is any item required to be taken into account by subtitle A for the partnership's taxable year to the extent it is determined by regulation that such item is more appropriately determined at the partnership level than at the partner level. Section 6231(a)(3). The partnership aggregate, and each partner's share of, items of income, gain, loss, deduction and credit of the partnership are expressly defined by the regulations as partnership items. Treas. Reg. § 301.6231(a)(3)- 1(a)(1)(i). In addition to those items that may be directly reported by the partnership, the regulations also state that partnership items include "factors that affect the determination of partnership items." Treas. Reg. § 301.6231(a)(3)-1(b).

A computational adjustment is the change in tax liability of a partner that properly reflects the treatment of a partnership item. Section 6231(a)(6). A computational adjustment also includes any interest attributable to such tax. Treas. Reg. § 301.6231(a)(6)-1T(b). Assessment of tax pursuant to a computational adjustment is specifically excluded from the deficiency procedures by Section 6230(a)(1).

An affected item is "any item to the extent such item is affected by a partnership item." Section 6231(a)(5). The regulations clarify that affected items include "items unrelated to the items reflected on the partnership return." Temp. Treas. Reg. § 301.6231(a)(5)-1T. By definition, the tax treatment of affected items depends on partnership-level determinations. Maxwell v. Commissioner, 87 T.C. 783, 792 (1986).

There are two types of affected items: (1) those that only require a computational adjustment once the partnership proceeding is complete and (2) those which require partner level determinations to be made once the partnership level proceeding is complete. See Maxwell, 87 T.C. 783; N.C.F. Energy Partners, 89 T.C. 741. Affected items which do not require partner level determinations are not the subject of either an FPAA or a notice of deficiency, but rather are made as computational adjustments subsequent to the partnership proceeding. Section 6230(a)(1); Temp. Treas. Reg. § 301.6231(a)(6)-1T. The preclusive effect of final partnership level determinations in TEFRA proceedings applies to partnership-level determinations as to both partnership items and affected items. Smith v. Commissioner, T.C. Memo. 1990-510. Thus, computational adjustments for such affected items are automatically applied to individual partners even though affected items which require partner level determinations may subsequently be litigated in deficiency proceedings.

Additions to tax are affected items which require factual determinations to be made at the partner level. Temp. Treas. Reg. § 301.6231(a)(5)-1T(d). The regulations specifically prohibit the making of computational adjustments with respect to additions to tax. Temp. Treas. Reg. § 301.6231(a)(6)-1T(c). Unless the individual partner concedes an affected item addition to tax, the addition is subject to the normal deficiency procedures. Section 6230(a)(2)(A)(i).

In the case of the section 6659 addition to tax for valuation overstatements, it is necessary to determine the type of taxpayer and the amount of underpayment. N.C.F. Energy Partners, 89 T.C. at 746. In the case of the section 6662(b)(3) accuracy-related penalty for a substantial valuation misstatement, similar determinations are required. Although a partner can petition the Tax Court for a redetermination of the additions to tax, the prior partnership proceeding will be res judicata as to the partnership adjustments and the Tax Court can only make partner level determinations in the affected item proceeding. N.C.F. Energy Partners, 89 T.C. at 745; Woody v. Commissioner, 95 T.C. 193 (1990).

In Smith v. Commissioner, T.C. Memo. 1990-510, the taxpayer challenged the Service's determination, in an affected item notice of deficiency, of the addition to tax for valuation overstatement. The underlying basis for the addition was the overvaluation of partnership property. The valuation of the partnership asset was a necessary determination for purposes of computing the investment tax credit at the entity level and allocating that item to the partners. As a result, the property value was a partnership item under Treas. Reg. § 301.6231(a)(3)-1(b). Because the property value was a partnership item, petitioners were bound by the determination in the FPAA (from which no petition was filed). Thus, because the partner level issues (type of taxpayer and amount of underpayment) were established, the substantial valuation overstatement addition applied.

Partnership items are limited to items required to be taken into account under any provision of subtitle A. The Tax Court lacks jurisdiction over section 6621(c) increased interest in partnership level proceedings. "Section 6621(c) is within subtitle F, not subtitle A. Therefore, section 6621(c) interest is not a 'partnership item'. . . ." Affiliated Equipment Leasing II v. Commissioner, 97 T.C. 575, 577-78 (1991). Although the section 6621(c) increased rate of interest is not itself a partnership item, a determination must be made to determine the extent to which it is impacted by partnership-level determinations. For the Service to be able to assert increased interest against a partner for a valuation overstatement, it is necessary to determine in a partnership proceeding the adjusted basis used by the partnership and the actual value of the property. See Hendrickson v. Commissioner, T.C. Memo. 1992-639. The Tax Court does not have jurisdiction to determine the applicability of section 6621(c) increased interest in an affected item proceeding when the statutory notice determines only additions to tax because interest is not a "deficiency" attributable to an affected item. White v. Commissioner, 95 T.C. 209 (1990).

Issue 1

Section 6659 provides for an addition to tax for any portion of an understatement attributable to a valuation overstatement for Year 1 and Year 2. Section 6662 provides for an accuracy-related penalty for a substantial valuation misstatement for Year 3, Year 4, and Year 5. Both sections provide that there is a "valuation overstatement" "if the value of any property, or the adjusted basis of any property claimed on the return is [a specified percent] or more of the amount determined to be the correct amount." For Year 1 and Year 2, the Commissioner has discretion to waive the addition to tax if the taxpayer can establish he had a reasonable basis for the valuation and the claim was made in good faith. Section 6659(e). For tax years 1989 and after, the accuracy-related penalty is not applicable if the taxpayer can prove reasonable cause and good faith.

For Year 1 and Year 2, depending on the amount of valuation or basis overstatement, the addition to tax varied from 10% to 30% of the portion of the understatement attributable to the incorrect valuation or basis claimed. For Year 3 and later years, the accuracy-related penalty is 20% of the understatement attributable to the substantial valuation/basis overstatement.

There are three requirements for the valuation overstatement addition to tax or misstatement penalty to apply: (1) a valuation overstatement or basis overstatement must exceed applicable percentages as provided by the Internal Revenue Code; (2) the resulting deficiency must exceed $1,000 for section 6659 or $5,000 for section 6662; and (3) the underpayment must be "attributable to" the valuation overstatement/basis overstatement. Here, the only issue is whether the first prong of the test has been met.

The meaning of the term "attributable to" creates a problem in any attempt to assert the section 6659 addition based on <u>valuation</u> overstatement utilizing the court's opinion in this case. This is because the court, in its opinion, did not arrive at a value for the property. It merely opined that the stated purchase price of the property was "many" times the actual fair market value. Further, the court's statements as to the value of the property was only one factor of several it considered in determining that partnerships never acquired the benefits and burdens of ownership of the property.

The Ninth Circuit gives a definite meaning to the term "attributable to." In order for an understatement to be "attributable to" a valuation overstatement, the understatement <u>must</u> result from the valuation overstatement. If the underpayment results from disallowance of deductions or credits for some reason <u>other than valuation</u>, then the addition to tax does not apply. <u>Gainer v. Commissioner</u>, 893 F.2d 225 (9th Cir. 1989), <u>aff'g</u>. T.C. Memo. 1988-416.

The facts in <u>Gainer</u> demonstrate the rule. Gainer purchased a limited partnership interest in a FoodSource shipping container. The total price the tax shelter claimed for the container was $260,000. That price was approximately four times the fair market value of the container. The Tax Court disallowed Gainer's claimed deductions and credits because his container had not been placed in service during the year he claimed the deductions. The Tax Court refused to subject Gainer to the section 6659 addition. It recognized (indeed the parties stipulated to) the fact that the value of the container had been substantially overstated. However, the Tax Court reasoned Gainer was not entitled to his claimed deductions because his container had not been placed in service during the year he claimed the deductions. Because the court disallowed Gainer's deductions on grounds other than valuation, the court reasoned the fact that the container was overvalued was not material. Gainer's tax liability (after adjusting for failure to place the container in service), was no different from his liability after adjusting for any overvaluation.

The Ninth Circuit in Gainer cited Todd v. Commissioner, 862 F.2d 540 (5th Cir. 1988), with approval. The Ninth Circuit determined that the Tax Court and the Fifth Circuit had properly applied the "formula" approach provided in the General Explanation of the Economic Recovery Act of 1981, which provided the following guideline for determining whether an underpayment was attributable to a "valuation overstatement:"

[T]he underpayment resulting from a valuation overstatement will be determined by comparing the taxpayer's (1) actual tax liability (i.e., the tax liability that results from a proper valuation which takes into account any other proper adjustments) with (2) actual tax liability as reduced by taking into account the valuation overstatement. The difference between these two amounts will be the underpayment that is attributable to the valuation overstatement.

In Gainer, the government argued that the result of the Ninth Circuit's opinion would mean "that where there are multiple grounds, including overvaluation, for a tax underpayment, no section 6659 penalty could ever be obtained." Gainer, 893 F.2d at 228. The Ninth Circuit rejected the government's argument, stating:

> That is true only when there is some ground for disallowing the entire portion of a deduction that otherwise might be disallowed for overvaluation. In other instances when multiple grounds exist, some portion of any underpayment may well be attributable to the overvaluation, and some portion to the other grounds. Id.

In Gainer, the government also argued that Irom v. Commissioner, 866 F.2d 545 (2d Cir. 1989), vacating in part and remanding T.C. Memo. 1988-211 should control. In Irom, the Second Circuit distinguished Todd and concluded that even if a court sustains a deficiency on a ground that would not be a basis for imposing section 6621(c), if there is a ground for imposing the section which is "inseparable from" the ground upon which the deficiency is sustained, the increased rate of interest would apply. The Tax Court has adopted the "inseparable" distinction in analyzing the applicability of both sections 6659 and 6621(c). McCrary v. Commissioner, 92 T.C. 827 (1989) (Section 6621(c) applies when a category of tax motivated transaction is “an integral part of or inseparable from” the grounds for disallowance of an item of deduction); Wilson v. Commissioner, T.C. Memo. 1989-266 (Sections 6659 and 6621(c) imposed because overvaluation “inseparable” from lack of economic substance, the ground for disallowing the deficiency); Jackson v. Commissioner, T.C. Memo. 1990-520 (Sections 6659 and 6621(c) imposed because valuation was “integral” to disallowance of deduction on lack of profit grounds).

In Gainer, the Ninth Circuit claimed that the Irom opinion was consistent with its own opinion. The Ninth Circuit stated that Irom had distinguished Todd on the basis that overvaluation was irrelevant in Todd because the containers involved in that case were not placed in service during the relevant tax years. Gainer, 893 F.2d at 229.

The value of the property was only one factor of several the Tax Court considered in this opinion in determining that partnerships never acquired the benefits and burdens of ownership of the property. [redacted]

[redacted] In Zirker v. Commissioner, 87 T.C. 970 (1986), the court imposed the section 6659 addition to tax (and section 6621(c)) under circumstances where the depreciation and credits claimed by the taxpayer were totally disallowed. The court analyzed the transactions to determine whether the benefits and burdens of ownership passed from the purported seller to the taxpayer. The court concluded that the transaction was so lacking in economic substance that it was not a sale for federal tax purposes. The court determined that because no sale occurred, that the petitioners' "correct" adjusted basis in the cattle was zero. The court imposed the valuation overstatement on the "overstated basis" prong of section 6659. It determined that a valuation overstatement existed because the taxpayers claimed an adjusted basis in the cattle ($41,500) that exceeded the correct adjusted basis (zero), by more than 250%, or more than the required percentage. See also, Clayden v. Commissioner, 90 T.C. 656 (1988). The court limited the valuation overpayment to the portion of the deficiency attributable to the disallowed basis. It found allowance of the depreciation deduction was dependent on the taxpayer establishing basis. It determined that because the taxpayer could not determine basis, the portion of the deficiency attributable to the disallowance of the depreciation deduction was subject to the section 6659 penalty. However, the court held that the other deductions (interest and operating expenses) claimed by the taxpayers did not create an underpayment attributable to a valuation overstatement. Zirker, 87 T.C. at 978-80.

In Massengill v. Commissioner, 876 F.2d 616, 619-20 (8th Cir. 1989), aff'g 1988 T.C. Memo. 428, the Eighth Circuit analyzed the circumstances surrounding the taxpayers' cattle transactions to determine whether alleged purchases of cattle should be recognized for tax purposes. It concluded, as had the Tax Court, that the taxpayers had no real obligation to make payments for the cattle, that the benefits and burdens of ownership had not been transferred to them, and that no purchases had occurred for tax purposes. Under these circumstances, the court upheld the imposition of the section 6659 addition to tax (and additional interest under section 6621(c)) finding that the taxpayers' correct basis in the cattle was zero because no sale had taken place. The court specifically rejected the argument, based upon Todd, that without an ownership interest in the cattle they could not be placed in service and therefore the taxpayers could not be liable for the section 6659 addition to tax. Massengill, 876 F.2d at 619.

Both the Second and Sixth Circuits have agreed with the Eighth Circuit's analysis in Massengill, holding that, when an underpayment stems from disallowed depreciation deductions due to lack of economic substance, the deficiency is attributable to overstatement of value, and subject to the section 6659 addition to tax (and additional interest under section 6621(c)). See Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991), cert. denied 502 U.S. 1031 (1992); Donahue v. Commissioner, 959 F.2d 234 (6th Cir. 1992) aff'g T.C. Memo. 1991-181.

To sum up: An understatement of tax must result from a valuation or basis overstatement for the section 6659 (or section 6662) addition to tax to apply. Here, the partnerships' losses were disallowed because the court found that the partnerships had not acquired the benefits and burdens of ownership of the partnership property. The court rejected the partnerships' claimed interest deductions because the purported recourse promissory notes were not valid indebtedness. The court also stated that the price the partnerships claimed to have paid for the partnership property was many times the actual fair market value, although the court did not find an actual fair market value. As in Zirker and Massengill, here an underpayment of tax resulted from basis overstatement to the extent of the depreciation deductions claimed by the partnerships. Consequently, the section 6659 penalty (or section 6662 penalty) should be asserted with respect to that portion of the individual partners' underpayments resulting from disallowed depreciation deductions.

Issue 2

Section 6621(c) provides an increased interest rate for any substantial underpayment attributable to a tax motivated transaction. The Omnibus Budget

Reconciliation Act of 1989 (Pub. L. 101-239) repealed section 6621(c); therefore it only applies to Year 1 and Year 2.

Section 6621(c)(2) defines a "substantial underpayment attributable to tax motivated transactions" as any underpayment of taxes attributable to one or more tax motivated transactions if the amount of the underpayment for such year exceeds $1,000. Section 6621(c)(3) defines "tax motivated transactions" as the following:

> (i) Any valuation overstatement (within the meaning of Section 6659(c));
>
> (ii) Any loss disallowed by reason of Section 465(a) and any credit disallowed under Section 46(c)(8);
>
> (iii) Any straddle (as defined in Section 1092(c) without regard to Subsections (d) and (e) of Section 1092);
>
> (iv) Any use of an accounting method specified in regulations prescribed by the Secretary as a use which may result in a substantial distortion of income for any period; and
>
> (v) Any sham or fraudulent transaction.

Section 6621(c)(3)(B) granted the Secretary authority to specify other types of transactions which could trigger the penalty. <u>See</u> Treas. Reg. § 301.6621-2T.

Section 6621(c) provides for interest at 120 percent of the normal rate.

The interest on substantial underpayments attributable to tax motivated transactions is a strict liability statute. There are no defenses to the imposition of the increased interest rate when the requirements of the statute are met. Accordingly, reasonable cause and good faith are not defenses to section 6621(c). <u>Williams v. Commissioner</u>, T.C. Memo. 1988-6; and <u>Cranfill v. Commissioner</u>, T.C. Memo. 1988-478.

Only four of the five "tax motivated transactions" outlined in the statute and regulations could potentially apply to the facts presented here. They are discussed below:

(1) Valuation Overstatement. Section 6621(c) provides that a valuation overstatement within the meaning of section 6659(c) supplies a basis for application of the tax motivated interest penalty. As discussed above in the section concerning application of section 6659, the <u>Zirker</u> and <u>Massengill</u> cases determined

that basis overstatement exceeding certain Code required percentages will result in application of both the section 6659 and 6621(c) additions. Because the court in its opinion, found that the petitioners never obtained the benefits and burdens of ownership, the court's opinion is indistinguishable from the opinions in Zirker and Massengill. Consequently, the court's opinion here will support assertion of the section 6621(c) addition to the portion of the individual partners' underpayments resulting from disallowed depreciation deductions.

(2) Section 465. The Service did not argue the at risk provisions of section 465 in the partnership litigation. The court did not reference section 465 in its opinion. However, the court did conclude that the partnership debt purportedly assumed by the partners was not valid indebtedness. Because the court determined the debt was neither recourse nor valid, we believe section 465 would apply, and would form the basis for assertion of additional interest pursuant to section 6621(c) to the amounts of any deductions claimed by the individual partners which exceeded the amount of money they contributed to the partnerships.

(3) Use of accounting method which substantially distorts income. The regulations promulgated by the Secretary in connection with section 6621(c)(3)(A)(iv) prescribe accounting methods that may "result in a substantial distortion of income." One of the qualifying deductions (or methods) is described as follows: "In the case of a taxpayer who computes taxable income using the cash receipts and disbursements method of accounting, any deduction disallowed for any period because ... the deduction resulted in a material distortion of income (see, e.g., Rev. Rul. 79-229, 1979-2 C.B. 210)." Treas. Reg. § 301.6621-2T Q&A3. On several occasions, the Tax Court has determined that the simple disallowance of deductions (on a basis other than the material distortion of income) did result in a "material distortion of income" under the foregoing provision. See Bailey v. Commissioner, 90 T.C. 558 (1988), aff'd in part, vacated in part, and remanded (without discussion of this issue), 912 F.2d 44 (2d Cir. 1990); Segal v. Commissioner, T.C. Memo. 1992-390, aff'd, 41 F.3d 1144 (7th Cir. 1994). However, the more reasoned opinions appear to limit the provision to deductions that have some business purpose or economic effect, outside the creation of tax benefits (e.g., timing and deferral issues normally argued under section 446). See, e.g., Lieber v. Commissioner, T.C. Memo. 1993-391; Isenberg v. Commissioner, T.C. Memo. 1987-269; and Schwartz v. Commissioner, T.C. Memo. 1987-381. We do not believe "substantial distortion" provides a basis for applying the penalty.

(4) Sham transaction. The Service did not argue sham in the partnership cases. The Tax Court skirted the issue in its opinion, but did not make a specific finding of sham. With respect to the portion of the computational adjustment attributable to the disallowed interest deductions, the Service could argue the requisite "sham" existed in order to assert the tax motivated interest penalty. The Tax Court has stated it believes "that a holding that a debt is not a bona fide debt is

indistinguishable from a holding that such a debt is a sham within the meaning of section 6621(c)(3)(A)." Bailey, supra.

The Tax Court opinion provides findings which would allow the Service to assert the section 6621(c) penalty on the portion of the computational adjustment attributable to deductions disallowed by the court because of a basis overstatement. The Service could also assert the section 6621(c) penalty on the portion of the computational adjustment attributable to deductions disallowed by the court because it found the partnership notes were not valid indebtedness. The Service would have to make a separate computation for each partner in order to assert this penalty.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

Please call if you have any further questions.

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