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

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER  
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT: Substantive Consolidation of TEFRA Entities

This Field Service Advice responds to your memorandum dated May 12, 1998. 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

Partnerships	=
Partnership Business	=
Investor Partnerships	=
Sales Partnership	=
Management Partnership	=
Operational Partnership	=
X	=
Y	=
Date 1	=
Date 2	=

ISSUE<sup>1</sup>

To what extent would the substantive consolidation of a group of partnerships by a bankruptcy court impact TEFRA proceedings with regard to partners of those partnerships?

CONCLUSION

Because the partnership is not a party to a TEFRA proceeding, the consolidation of by bankruptcy court of a group of partnerships will not impact the TEFRA proceeding.

FACTS:

At the time of your request, there are two cases pending before the bankruptcy court involving two partnerships of a group of related partnerships. The partnerships are a series of tax shelters involving Partnership Business. The shelter includes Investor Partnerships, which purchased Partnership Business from Sales Partnership. The investor partnerships also pay management fees to Management Partnership. Lastly, money flowed to Operational Partnership, which operated the facilities for the Partnership Business. There are over X investors in a total of Y Investor Partnerships. The Sales, Management, and Operational Partnerships are essentially comprised of the founders and promoters of the tax shelter.

Operational Partnership filed a Chapter 11 petition and a plan has been confirmed. The Sales and Management Partnerships were forced into involuntary bankruptcy by a group investors, and those cases are pending. A United States Trustee was appointed to monitor the Sales and Management Partnerships' cases. The trustee initiated a declaratory judgement action in the Bankruptcy Court requesting that the court collapse all Partnerships (including the Investor Partnerships that were not before the court) into a single entity. The basis for collapsing such entities is that all of the entities have shared common accounts and books and records. From a bookkeeping standpoint, the partnerships have made no meaningful distinctions among themselves, and from a practical standpoint, have operated as a single enterprise.

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<sup>1</sup>Due to events that occurred during the time this request for advice was pending, several issues raised in your original request have been rendered moot. Accordingly, we are limiting our response to the sole issue that remains relevant following the court order regarding substantive consolidation.

Nearly all of the partnerships are subject to the TEFRA unified audit and litigation procedures and are either currently under examination or docketed before the Tax Court. Cases generally fall into four categories: under exam; docketed but not yet tried; docketed and awaiting opinion; and, decided. The result of these TEFRA proceedings consistently have been (and we believe will continue to be) deficiencies in the income tax liabilities of the partners. Also, several of the Investor Partnerships have been assessed late filing penalties, which are liabilities of the partnerships. Because the partners are all general partners, in some instances, these late filing penalties are being collected from the partners.

On Date 1 the Bankruptcy Court granted the trustee's motion to consolidate into one entity the two debtor partnerships with Y Investor Partnerships as of Date 2, the date the involuntary bankruptcies were filed. The motion was based on the inability to determine the relative ownership of the assets and liabilities of each partnership.

#### LAW AND ANALYSIS

The jurisdiction of the Bankruptcy Court is limited to matters "concerning the debtor." The Bankruptcy Code permits "determination by the bankruptcy court of any unpaid tax liability of the debtor that has not been contested before or adjudicated by a judicial or administrative tribunal of competent jurisdiction before the bankruptcy case." S. Rep. No. 95-989 (1978); see also 11 U.S.C. § 505. Though the court may determine that the debtor partnerships are a common enterprise with the Investor Partnerships, this should have no impact on the TEFRA unified audit and litigation procedures.

In 1982, Congress enacted the TEFRA<sup>2</sup> unified audit and litigation procedures to simplify and streamline the partnership audit, litigation, and assessment process. The underlying principle of TEFRA is that "the tax treatment of items of partnership income, loss, deductions, and credits will be determined at the partnership level in a unified partnership proceeding rather than separate proceedings with the partners."<sup>3</sup> Accordingly, the Service may examine the partnership as an entity, rather than conduct a separate examination as to each of the partners.

Despite the creation of a unified procedure for audit and litigation, the manner of tax reporting and assessment is not affected by TEFRA and it is the partners that are the true subject of a TEFRA proceeding. The Conference Report

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<sup>2</sup>Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248.

<sup>3</sup>Conf. Rep. No. 97-248 at 600 (1982), 1982-2 C.B. 462.

to TEFRA expressly notes that “[f]or income tax purposes, partnerships are not taxable entities. Instead, a partnership is a conduit, in which the items of partnership income, deduction, and credit are allocated among the partners for inclusion in their respective income tax returns.”<sup>4</sup> For example, a partnership files a Form 1065 “U.S. Partnership Return of Income”; however, this form is merely an informational return that sets forth the amounts of partnership items and includes schedules allocating such items among the partners. The enactment of TEFRA merely set forth rules as to the administrative procedures for making adjustments to these items: taxes continue to be assessed against the partners and the partnership continues to be a mere conduit for tax purposes.

The issue of the interplay between a partnership in bankruptcy and a TEFRA proceeding has been addressed in numerous cases. Most notably, in 1983 Western Reserve Oil & Gas Ltd. v. Commissioner, 95 T.C. 51 (1990), the Tax Court addressed the impact of the bankruptcy stay on a TEFRA proceeding when the partnership was in bankruptcy. The court noted that for bankruptcy purposes, a partnership is an entity separate and distinct from its partners. Id., 95 T.C. at 56. Most importantly, the court noted that, although a TEFRA proceeding determines partnership items, “[u]ltimately, however, it is the tax liability of the individual partners which is affected by the redetermination of the adjustments as to the return of the partnership.” Id., 95 T.C. at 57. In reaching its conclusion, the Tax Court relied heavily on American Principles Leasing Corp. v. United States, 904 F.2d 477 (9th Cir. 1990), which expressly held that ‘section 505 does not permit the bankruptcy court to determine the tax liabilities of the non-debtor partners.’ Id., 904 F.2d at 481.

Most recently, this issue was addressed in Hoyt and Sons Ranch Properties, Ltd. v. Commissioner, T.C. Memo. 1998-77, in which the court succinctly stated that:

because a TEFRA partnership proceeding ultimately concerns the tax liability of the partnership’s individual partners, and recognizing that a partnership in bankruptcy is an entity separate and distinct from its partners, we conclude that a partnership level proceeding may be commenced and concluded in this Court without violating the automatic stay.

The courts have repeatedly recognized that a bankruptcy court cannot exercise jurisdiction over the tax matters of non-debtor partners of a partnership in bankruptcy.

### Late Filing Penalties

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<sup>4</sup>Conf. Rep. No. 97-248, at 599 (1982), 1982-2 C.B. 462.

With regard to the late filing penalties imposed on the partnership, we reach a different conclusion. A TEFRA proceeding is a proceeding with respect to partnership items of the partners in the aggregate. I.R.C. § 6221. Partnership items are, by definition, limited to items required to be taken into account by the partnership under subtitle A. I.R.C. § 6231(a)(3). Late filing penalties are imposed by subtitle F, and thus are not subject to the TEFRA proceeding. Accordingly, the above analysis regarding the impact of the partnership's bankruptcy on the TEFRA proceeding is inapplicable. The late filing penalty at issue in this case was imposed pursuant to I.R.C. § 6698, which expressly imposes liability for the penalty on the partnership. I.R.C. § 6698(c). Section 505(a)(1) of the Bankruptcy Code vests the bankruptcy court with jurisdiction to determine the amount of any penalty relating to a tax. Because this penalty is imposed on the debtor partnership, it may be determined by the bankruptcy court.

If you have any further questions, please call (202) 622-7950.

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