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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
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SUBJECT: Application of I.R.C. § 6621(c) Interest to Sham Transactions
of a TEFRA Partnership

This Field Service Advice responds to your memorandum dated July 2, 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.

ISSUES

1. Whether the increased rate of interest on substantial underpayments of tax attributable to tax motivated transactions is a partnership item.
2. Whether the determination that the partnership engaged in a sham transaction must be made in the partnership proceeding.
3. Whether, for purposes of applying the increased rate of interest, partners who enter into a settlement of partnership items would be bound by a subsequent decision in the related TEFRA partnership case that the underlying partnerships engaged in sham transactions.

CONCLUSION

1. The increased rate of interest on substantial underpayments of tax attributable to tax motivated transactions is not a partnership item.

2. The determination that the partnership engaged in a sham transaction may be made in the partner-level proceeding.
3. For purposes of applying the increased rate of interest, partners who enter into a settlement of partnership items would not be bound by a subsequent decision in the related TEFRA partnership case that the underlying partnerships engaged in sham transactions. Nonetheless, the outcome of the TEFRA proceeding may have a strong impact on the determination of whether the underlying partnership engaged in a sham transaction in any subsequent action challenging the applicability of the increased rate of interest.

FACTS

With regard to a group of partnerships that are subject to the TEFRA unified audit and litigation procedures, the Service and several investors executed forms 870-P with regard to partnership items. None of the agreements expressly addressed the applicability of the increased rate of interest on the face of the form or the attached schedule of adjustments. Some investors received an attachment indicating that the increased rate of interest would apply. None of the agreements set forth the underlying basis for imposing the increased rate of interest.

LAW AND ANALYSIS

The sole issue for consideration is the applicability of the increased rate of interest. The resolution of this issue rests primarily upon the application of the TEFRA unified audit and litigation procedures to the settlements that have been executed in these related cases.

Former I.R.C. § 6621(c) Increased Interest

Former section 6621(c) increased the interest rate to 120% of the statutory rate on substantial underpayments of tax that exceeded \$1,000 that were attributable to "tax motivated transactions," as that term was defined in section 6221(c)(3). This provision was repealed for returns due after December 31, 1989 (without regard to extensions). Pub. L. No. 101-239, § 7721(b). The Code defined tax motivated transactions as:

- Any valuation overstatement (within the meaning of former section 6659(c)),
- Any loss disallowed by reason of section 465(a) and any credit disallowed under section 46(c)(8),

- Any straddle (as defined in section 1092(c) without regard to subsections (d) and (e) of section 1092),
- 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
- Any sham or fraudulent transaction.

The temporary regulations enumerate several accounting methods that might have resulted in a substantial distortion under section 6621(c)(3)(A)(iv). See Temp. Treas. Reg. § 301.6621-2T (A-3). Also, section 6621(c)(3)(B) authorized the Secretary to specify by regulation other types of transactions that would have been treated as tax motivated transactions. Temporary Treas. Reg. § 301.6621-2T (A-4) added the following:

- Any deduction disallowed for any period under section 183, relating to an activity engaged in by an individual or an S corporation that is not engaged in for profit, and
- Any deduction disallowed for any period under section 165(c)(2), relating to any transaction not entered into for profit.

The determination of whether the increased rate of interest applies is generally based upon the nature of the underlying transactions. For example, if the underlying transactions are determined to be “sham transactions,” the increased rate of interest applies by operation of law. Durrett v. Commissioner, T.C. Memo. 1994-179. Similarly, the same result would be reached if it were determined that any of the specified prohibited accounting methods were used. The taxpayer’s individual profit motive is irrelevant once it is determined that the transaction meets any of the specified criteria.

By contrast, the increased rate of interest may be imposed based upon a partner’s individual profit motive. Temp. Treas. Reg. § 301.6621-2T(A-4)(1). If the increased rate of interest is imposed based upon profit motive, the necessary inquiry looks at the intentions of the taxpayers. Heasley v. Commissioner, 902 F.2d 380 (5th Cir. 1990). In Durrett, the Tax Court distinguished Heasley, noting that “[w]hen a transaction is the simple product of smoke and mirrors, it is a factual sham, regardless of whether the taxpayer may have thought that a profit might have been made.” The court held that the determination that the transaction is a sham, without regard to profit motive, is sufficient to determine that the increased rate of interest applies. Durrett, citing H.R. Conf. Rep. No. 99-841 (1986), 1986-3 C.B. (Vol. 4) 796.

The ultimate issue in the present matter is whether the determinations that result in the application of the increased rate of interest must be made in

accordance with TEFRA procedures. Such an inquiry necessarily focuses on the scope of the TEFRA provisions.

TEFRA Generally

In 1982, Congress enacted the TEFRA¹ 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."² Once partnership determinations become final, the Service and the partners are bound by those determinations. I.R.C. § 6230.

Partnership Items

With the enactment of TEFRA, Congress established a unified audit and litigation proceeding through which determinations as to partnership items are required to be made at the partnership level. I.R.C. § 6221. 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. I.R.C. § 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). Such factors include the accounting practices of the partnership and whether the partnership is engaged in an activity for profit. Id.

For purposes of determining whether the increased rate of interest is a partnership item, the inquiry ends with the statutory definition of partnership items. Partnership items are limited to items required to be taken into account under any provision of subtitle A. As the Tax Court has succinctly stated, "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). Our inquiry, however, does not end there. In addition to partnership items, the preclusive effect of the TEFRA proceedings also applies to partnership-level determinations as to affected items. Smith v. Commissioner, T.C.

¹Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248.

²H.R. Conf. Rep. No. 97-760, at 600 (1982), 1982-2 C.B. 600, 662.

Memo. 1990-510. Thus, though the increased rate of interest is not itself a partnership item, we must determine the extent to which it is impacted by partnership-level determinations.

Affected Items

An affected item is “any item to the extent such item is affected by a partnership item.” I.R.C. § 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).

In N.C.F. Energy Partners v. Commissioner, 89 T.C. 741 (1987), the Tax Court held that the increased rate of interest is an affected item of the type that may require findings of fact peculiar to the particular partner. One of the partnership item components is the deficiency that gives rise to the interest, in that the amount of the deficiency is determined by taking into account partnership items. Barton v. Commissioner, 97 T.C. 548, 551 (1991). The determination as to whether the partnership engaged in a tax motivated transaction, however, is not necessarily a partnership item. Affiliated Equipment Leasing II v. Commissioner, 97 T.C. 575, 579 (1991).

In Affiliated Equipment Leasing, the investors argued that the Tax Court had jurisdiction in the partnership-level proceeding to determine “whether an item is attributable to a tax motivated transaction” and that the applicability of the increased rate of interest would merely flow from the partnership item determination. The taxpayers argued that Treas. Reg. § 301.6231(a)(3)-1(b), which includes the character of an item in the definition of partnership items, includes the underlying determination of whether the increased rate of interest applies. The Tax Court rejected this argument.

Though not directly addressing the increased rate of interest, Smith v. Commissioner, T.C. Memo. 1990-510, is instructive on this point. In Smith, the taxpayer challenged, inter alia, the penalty for a substantial valuation overstatement. The Service issued an affected item notice of deficiency setting forth the substantial valuation overstatement penalty. The underlying basis for the penalty was the overvaluation of partnership property. The partnership had valued the property in excess of six million dollars; whereas the Service had issued a notice of final partnership administrative adjustment in which it was determined that the value of the property was zero. The valuation of the partnership asset was a necessary determination under subtitle A for purposes of computing the investment tax credit at the entity level and allocating that item to the partners. As a result, it was a partnership item under Treas. Reg. § 301.6231(a)(3)-1(b). Because the

value of the property was a partnership item, petitioners were bound by the determination in the FPA (from which no petition was filed). Thus, the substantial valuation overstatement penalty applied.

Similarly, for purposes of determining the applicability of the increased rate of interest, to the extent subtitle A determinations are underlying components of the tax motivation inquiry, such determinations are partnership items.³ As the Tax Court noted in Dial USA, Inc. v. Commissioner, however, the critical factor is whether the determination is required to be determined at the entity level. 95 T.C. 1, 4 (1990). As noted at the outset, the increased rate of interest may be imposed under a variety of circumstances. Whether the components that underlie the application of the increased rate of interest are partnership items must be determined in light of the applicable definition of tax motivation.

Partnership Item Components of Tax Motivation

As noted at the outset, the increased rate of interest may be imposed under a variety of circumstances. Those circumstances constitute the underlying basis for imposing the increased interest. Whether the underlying basis for imposing the increased rate of interest is a partnership item will depend upon whether it is required to be determined by the partnership under subtitle A.

One example is the imposition of the increased rate of interest when there is a valuation overstatement within the meaning of former section 6659(c). In Smith v. Commissioner, T.C. Memo. 1990-510, the Tax Court held that underlying components of the substantial valuation overstatement penalty are partnership items (specifically, the value placed on the asset by the partnership and the actual value of the asset). Those same items are components of the tax motivation determination under former section 6621(c)(3)(A)(i). Thus, to the extent those components must be determined in the partnership proceeding for purposes of determining the adjustment to items that are required to be taken into account under subtitle A, those items must also be determined in the partnership proceeding for purposes of determining the applicability of increased interest.

As applicable to this case, a sham or fraudulent transaction may also give rise to the imposition of the increased rate of interest. If it is determined that the partnership engaged in sham transactions resulting in the adjustment of partnership items, such an adjustment will automatically give rise to the imposition of the

³An example of the partnership item component approach to affected items commonly occurs with regard to basis determinations. See, e.g., University Heights at Hamilton Corp. v. Commissioner, 97 T.C. 278 (1991) (addressing S corporation-level determinations as components of basis, which is an affected item).

increased rate of interest; however, the sham determination is only a partnership item to the extent it must be determined in the partnership proceeding for purposes of determining the adjustment to items that are required to be taken into account under subtitle A. See Treas. Reg. § 301.6231(a)(3)-1(b).

The Present Situation

In the above examples, we concluded that a determination at the partnership level that a transaction or the partnership as a whole met one of the criteria specified in section 6621(c)(3) results in the automatic application of the increased rate of interest. In the present situation, however, the partners executed forms 870-P that were silent as to the application of the increased rate of interest and did not expressly indicate the underlying basis for imposing the increased rate of interest. In some instances, those determinations may be required to be made under subtitle A. This occurs when the issues underlying the resulting deficiency involve those same subtitle A determinations. Absent such a required subtitle A determination, tax motivation is not required to be determined at the entity level. Affiliated Equipment Leasing, 97 T.C. at 577-78; Dial, 95 T.C. at 4. The confusion arises because the tax motivation underlying the application of the increased rate of interest is inextricably interwoven with the underlying merits of the partnership proceeding. Nonetheless, unless the tax motivation criteria is a required subtitle A determination, it is not a partnership item. Affiliated Equipment Leasing, 97 T.C. at 577-78.

In the instant case, the partnership item adjustments set forth in the FPAAs were based on the Commissioner's determination that the partnerships engaged in a sham transaction. Some partners entered into settlements that are silent on the sham issue. Because the determination that the partnership engaged in a sham transaction is not a determination required under subtitle A, the absence of such a determination is not fatal to its assertion.

Unlike the substantial valuation overstatement penalty, which requires subtitle A determinations, a determination that a transaction is a sham is not required to be taken into account under subtitle A. Furthermore, the assertion that the partnership engaged in a sham transaction is consistent with the FPAAs issued in this case. Accordingly, the determination that the partnership engaged in a sham transaction is not a partnership item.

We recognize that the sham determination is akin to a partnership item in that it may be determined in the partnership proceeding and binding on all partners, and that such a partnership-level determination would be consistent with the objectives of TEFRA to reduce duplicative proceedings. As the Tax Court stated in N.C.F. Energy Partners, 89 T.C. at 746-47:

We appreciate petitioner's concern for avoiding repetitive litigation. We doubt, however, that the litigation will be repetitive; it has been organized by statute to avoid chaotic and disparate results. Any future litigation at the partner level will not be repetitive of the partnership level proceeding. The doctrine of res judicata will apply to preclude the parties from relitigating any issue already resolved in the partnership proceeding, for example, the value or basis of partnership assets.

In focusing on the principles of res judicata (or what should more properly be characterized as collateral estoppel), the Tax Court clarified how determinations made in a partnership proceeding, such as the determination that a partnership is a sham, may be binding on the partners without necessarily being a partnership item. A partner is generally a party to the TEFRA proceeding, and thus is precluded from relitigating issues that were determined in the prior proceeding even absent the statutory provisions regarding finality as to partnership items.

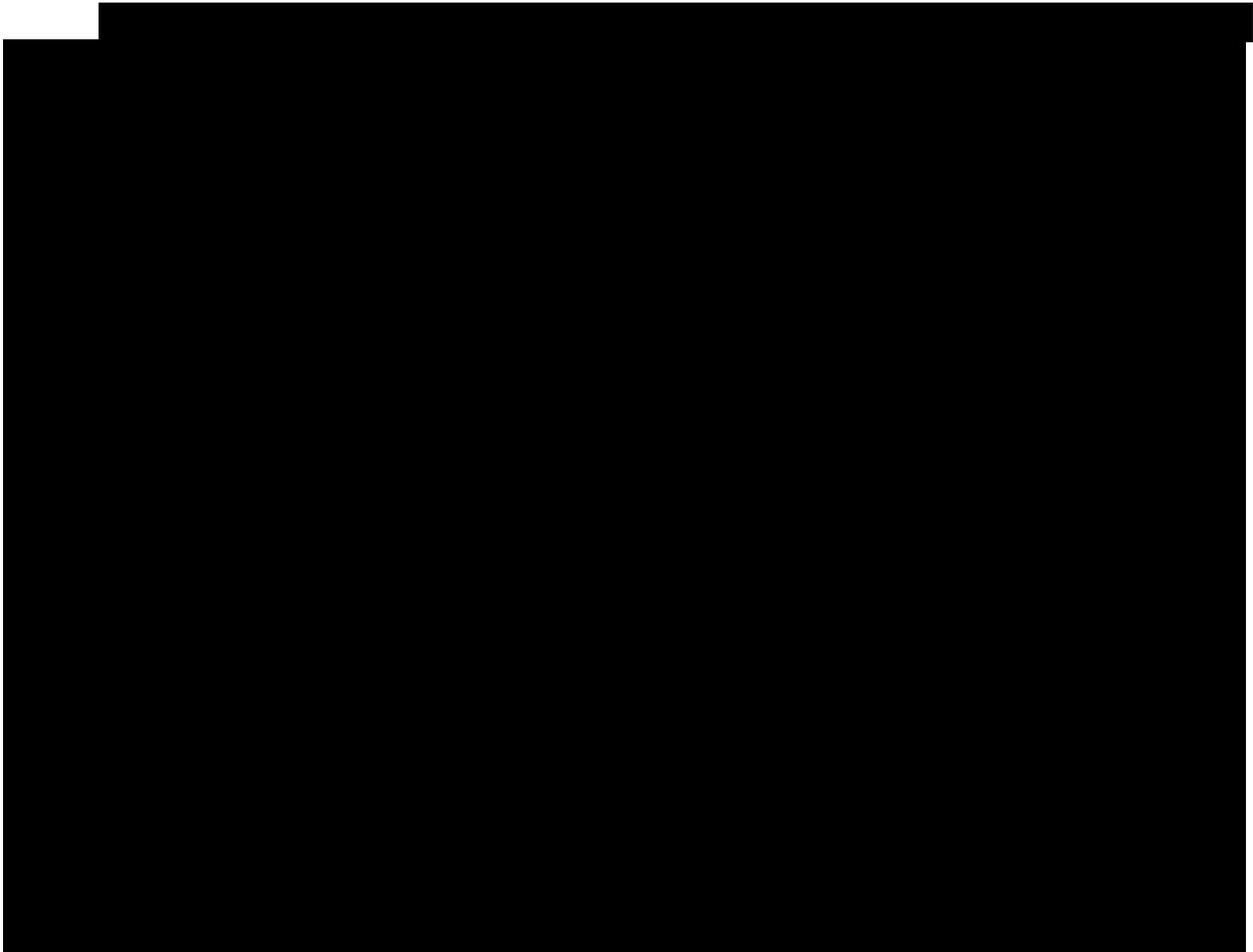
In sum, the determination that a partnership engaged in a sham transaction for purposes of imposing the increased rate of interest on substantial underpayments of tax attributable to tax motivated transactions is an affected item, not a partnership item. This is consistent with those cases which have held that we look to the partnership proceeding to determine whether the facts lead to the conclusion that the tax motivation inquiry is satisfied, because though not a partnership item, partners may be collaterally estopped from challenging a determination in a TEFRA proceeding that the partnership engaged in a sham transaction.⁴

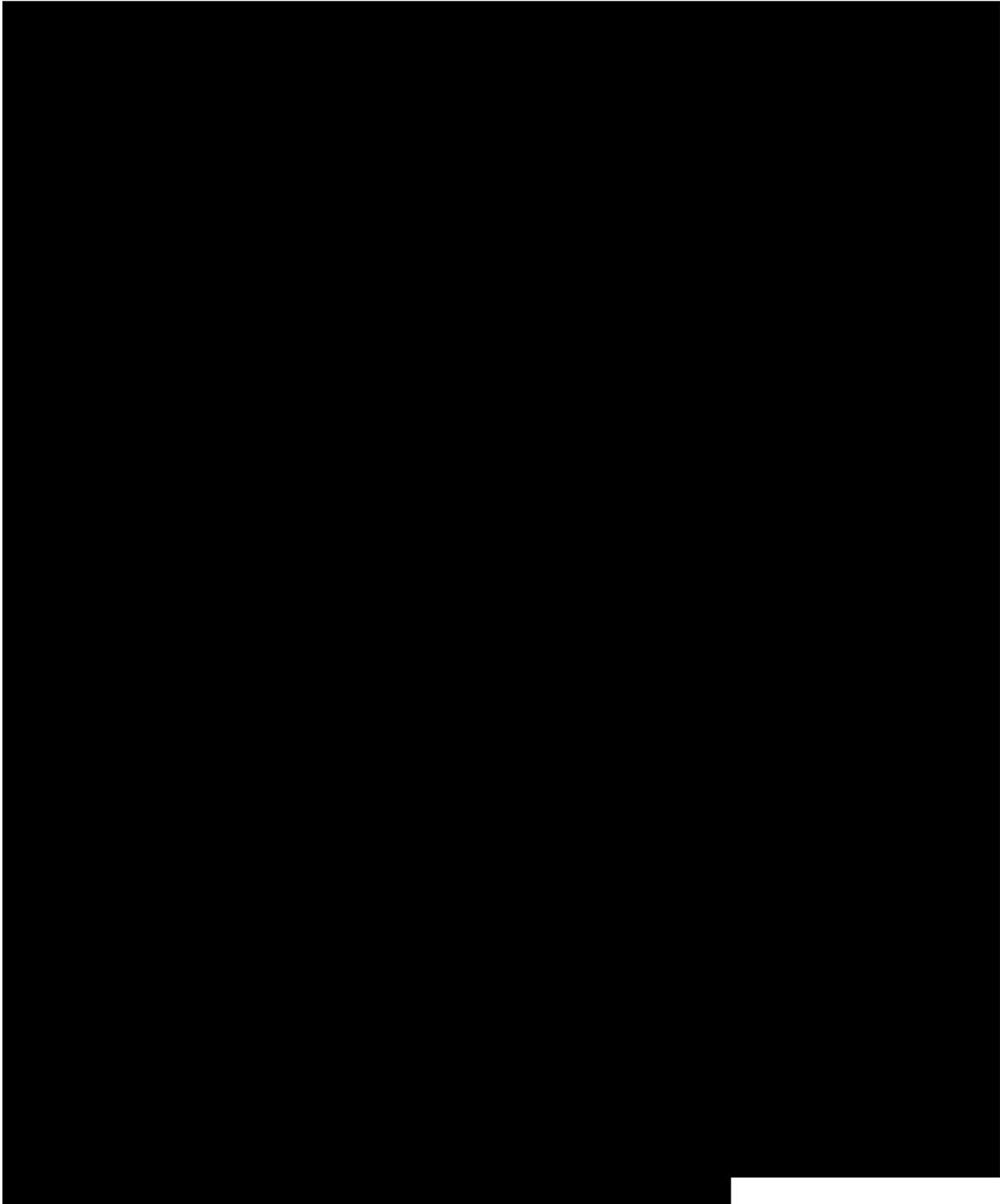
As a secondary issue, you have inquired whether a subsequent determination in a TEFRA proceeding that the partnership engaged in a sham transaction would be binding on partners who had previously entered into a settlement. Section 6231(b)(1)(C) provides that partnership items convert to nonpartnership items when the partner enters into a settlement agreement. Once the partner's partnership items convert to nonpartnership items, the partner is no longer a party to the TEFRA proceeding. I.R.C. § 6226(d)(1)(A). Accordingly, the partner is not bound by the outcome of the proceeding. As noted by the Court of Federal Claims, "the value or treatment of the items in the hands of the individual partner is determined solely by the terms of the settlement agreement and the taxpayer's own circumstances, and not by any subsequent tax determination with respect to the partnership." Slovacek v. United States, 36 Fed. Cl. 250, 255 (1990).

⁴Likewise, the Service may similarly be estopped from arguing in a later proceeding that the partnership engaged in a sham transaction if it is determined in the TEFRA proceeding that the partnership did not engage in a sham transaction.

Though the partner is not bound to the outcome of the TEFRA proceeding, the TEFRA proceeding may, from a practical standpoint, be determinative of the outcome as to the issue of the increased rate of interest. For example, in the plastics recycling cases, the Tax Court held that certain transactions were shams and applied the substantial overvaluation penalty. See Provizer v. Commissioner, T.C. Memo. 1992-177. Though petitioners in related cases generally signed agreements to be bound, not all partners agreed to be bound to the outcome of Provizer. Nonetheless, rather than revisiting the underlying issues, the Tax Court often cited to the opinion in Provizer and where the parties failed to distinguish the facts, the court based its decision upon the holding in Provizer. See, e.g., Sann v. Commissioner, T.C. Memo 1997-259. A similar result is likely here. There are numerous partnerships with an identical structure, and there are thousands of partners. If the Tax Court were to hold in the TEFRA proceeding that the partnership engaged in a sham transaction, that opinion would be influential, though not binding, in any other proceeding.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS





If you have any further questions, please call (202) 622-7880.

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