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Is It a Partnership Item?

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In this report, Nardiello examines the legal authorities that define the term "partnership item" as it relates to the IRS's authority to make adjustments in a partnership-level proceeding, including the way the courts have interpreted that term and recent areas of expansion that have broadened the IRS's authority in those proceedings. The report also discusses the various considerations that may serve as strategic bases to challenge the IRS's characterization of a particular item as a partnership item and provides additional thoughts on current trends that now exist in the tax controversy landscape.

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Is the IRS attempting to adjust a partnership item? That is the first question one should ask upon receipt of a revenue agent's report or a notice of final partnership administrative adjustment for a partnership. If the answer is yes, the adjustment is the proper subject of the IRS proceeding against the partnership. If the answer is no, the IRS is exceeding its authority and the partnership has an affirmative defense to defeat the adjustment.[1] Successfully asserting a jurisdictional argument presents the possibility of litigating the item in a partner-level proceeding. Before one can effectively evaluate that argument, it is necessary to have an understanding of the fundamentals as set forth in the code and the corresponding regulations. After examining some of those items, this report will explore a few of the areas in which the IRS has sought to expand its authority.

The benefits of successfully challenging the IRS's authority to determine non-partnership items in a partnership proceeding are numerous and varied, and they warrant consideration in any practitioner's case strategy. A successful challenge to the characterization of items could result in a venue that is more taxpayer-favorable because of evidentiary, jury, or procedural considerations. On substantive legal issues, federal law generally will control in partner-level determinations. Federal law is usually consistent across the country, but there may be differences among the circuits.[2] If there is a circuit conflict, venue considerations could become relevant even when a partner expects to litigate a partner-level proceeding in Tax Court, because under the *Golsen* rule, the Tax Court generally will

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[1]One court recently commented on what it perceived as the government's failure to appropriately observe the distinction between partnership and non-partnership items. *See, e.g.*, *United States v. Steinbrenner*, 8:11-cv-2840-T-23AEP (M.D. Fla. 2013) ("Among the principal purposes of [the 1982 Tax Equity and Fiscal Responsibility Act] was to establish the boundary that the IRS, apparently in a misbegotten irredentist effort after TEFRA, seeks impermissibly in this action to disestablish, impinge, blur, or selectively ignore").

[2]A current example is the applicability of the 40 percent gross valuation misstatement penalty under section 6662(h) when the IRS entirely disallows a deduction attributable to basis in property for lack of economic substance, *e.g.*, a loss arising from or related to a partner's outside basis in a partnership. Only the Fifth and Ninth circuits have held that the penalty does not apply in that situation because any valuation misstatement was irrelevant to the calculation of the tax. *Bemont Investments LLC v. United States*, 679 F.3d 339 (5th Cir. 2012); *Keller v. Commissioner*, 556 F.3d 1056 (9th Cir. 2009). The Supreme Court has granted certiorari to resolve this issue, as well as that of a court's jurisdiction over the valuation misstatement penalty in a partnership proceeding. *United States v. Woods*, 133 S. Ct. 1632 (2013), No. 11-50487 (5th Cir. 2012), *aff'g* 794 F. Supp.2d 714 (W.D. Tex. 2011). This report will not address the issues in that pending case.

decide a proceeding in accordance with the law of the circuit to which the case is appealable.[3]

Another benefit of a successful challenge arises when a penalty would attach to an item. If a penalty ''relates to an adjustment to a partnership item,'' it is determined at the partnership level, where only partnership-level defenses can be raised.[4] If the partner has partner-level defenses to assert, his recourse generally is to pay the penalty and sue for a refund.[5] But if the item is properly characterized as a non-partnership item that requires partner-level determinations and gives rise to a penalty that is unrelated to a partnership item, the partner should be able to pursue a challenge in a partner-level proceeding in Tax Court without prepaying the penalty.[6]

Whether an item is a non-partnership item can also affect more practical, strategic considerations. A partner can exert greater control over the litigation process (for example, discovery, legal theories, and settlement) in a partner-level proceeding than in a partnership-level proceeding, without having to contend with the interests of the partnership and other partners. Moreover, if there are unsavory facts associated with other partners, a single partner may be able to avoid some of the potential taint to his case by litigating an item in a partner-level proceeding.

Although the law is unclear, the timeliness of a proposed IRS adjustment may be affected by whether it constitutes a partnership or non-partnership item. A statute of limitations defense generally does not arise because items that arguably fall into either category that are deemed not to be partnership items are usually affected items. This report will not address the statutes of limitation applicable to partnership- and partner-level proceedings, which are particularly complex. Suffice it to say, however, that upon the conclusion of a partnership-level proceeding, the IRS has additional time to issue a notice of deficiency to each partner to propose adjustments to affected items that require partner-level determinations.[7] On the other hand, if a court determines that an item is not a partnership item, and it is also found not to be an affected item, the IRS might be out of time because a pure non-partnership item should be subject to the individual three-year statute of limitations in section 6501(a) without any tolling for the partnership proceeding.[8]

One should also consider the consequences of not challenging a partnership item classification. The Tax Court has explained that once it decides that an item is a partnership item — that is, that it can exercise jurisdiction in a partnership-level proceeding — and the appeal process has been exhausted, that determination is final and binding in any future partner-level proceeding, even if it is erroneous.[9] Failing to raise a jurisdictional challenge to the partnership item classification in a partnership proceeding would interfere with a partner's ability to later argue that a court in a partner-level proceeding has jurisdiction to determine that item, and it would subject the partner to the determinations from the partnership proceeding.[10]

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[3]*Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

[4]Sections 6226(f) and 6230(c)(4); reg. section 301.6221-1(a). As discussed later in this report, the term ''relates'' in the context of the court's jurisdictional grant to determine penalties in a partnership proceeding is the subject of two appeals before the D.C. Circuit, as well as the *Woods* litigation before the Supreme Court.

[5]Reg. section 301.6221-1(d).

[6]Section 6230(a)(2).

[7]Sections 6229(d) and 6230(a)(2). For a detailed discussion of the statute of limitations in partnership proceedings, see Anisa Afshar, ''The Statute of Limitations for the TEFRA Partnership Proceedings: The Interplay Between Section 6229 and Section 6501,'' 64 *Tax Law*. 701 (2011).

[8]*See, e.g.*, *Alpha I LP v. United States*, 84 Fed. Cl. 209 (2008), *rev'd*, 682 F.3d 1009 (Fed. Cir. 2012), *petition for cert. pending*, No. 12-550 (filed Nov. 1, 2012) (after determining that partner identity was not a partnership item, the Court of Federal Claims rejected the government's alternative argument by finding that it was also not an affected item); *but cf. Grigoraci v. Commissioner*, T.C. Memo. 2002-202, at *22-*24 (''true and actual partner'' determination is an affected item). If a partner has not agreed to extend the statute of limitations, the IRS may pursue that partner under one of the extended statutes of limitation in section 6501, *e.g.*, based on a partner's substantial omission of income, false or fraudulent return, or willful attempt to evade or defeat a tax.

[9]*Thompson v. Commissioner*, 137 T.C. 220, 237-239 (2011) (''Petitioners may not, in this partner-level action, collaterally attack subject matter jurisdiction that we had previously exercised in the partnership-level proceeding. The findings in that proceeding are no longer subject to review by this Court'' because a valid jurisdictional judgment has preclusive effect, even if it is erroneous) (internal citations omitted); *rev'd on other grounds*, No. 12-1725 (8th Cir. 2013) (disagreeing with the lower court's determination that the court in the related partnership proceeding exercised jurisdiction over a particular item).

[10]*Id.* ''Secs. 6221, 6226(f) [the partnership item jurisdictional statute] and 6230(c)(4) embody the codification of collateral estoppel with respect to the partnership-level adjudication of partnership items. . . . Relitigating these items in a partner-level prepayment forum is, thus, statutorily estopped.'' *Id.* at 238, n.23. Failure by any of the partners to challenge an FPAA in a court proceeding seems to have the same preclusive effect. If an FPAA goes unchallenged, the IRS can make assessments against, and later collect from, the partners after the expiration of the 150-day period that begins the day after the FPAA is issued. Section 6225(a)(1). If a partner satisfies the assessment, that partner's refund actions are limited by section 7422(h), the jurisdictional statute on refund actions for partnership items, to a select few as described in section 6230(c) (if an FPAA has been issued). Any actions under that section are also limited by subsection 6230(c)(4), which states: ''For purposes of any claim

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I. TEFRA Fundamentals

With the enactment of the 1982 Tax Equity and Fiscal Responsibility Act, Congress created a procedural structure for examining and making adjustments to partnership and partner tax returns and litigating those adjustments.[11] The twin objectives of TEFRA's audit and litigation provisions are uniformity and efficiency.[12] Before TEFRA, the IRS would audit and propose separate adjustments for each individual partner, which led to inconsistencies and duplicative proceedings. TEFRA created a unified audit procedure for the IRS to examine and propose adjustments to the partnership that flow to the partners upon becoming final, who ultimately pay the tax. The partnership item is the centerpiece of that streamlined approach and the only proper subject of a partnership proceeding.[13]

A TEFRA partnership is broadly defined to include any partnership that is required to file a partnership tax return.[14] The code excepts from the TEFRA provisions small partnerships: those with 10 or fewer partners, each of whom is an individual, C corporation, or estate of a deceased partner.[15] However, small partnerships can elect to have TEFRA apply.[16]

Practice in the TEFRA world requires an understanding of multiple terms that frequently appear throughout its provisions. Although section 6231(a) is dedicated to defining those terms, resort to the regulations and case law is a necessity.

A. Partnership Item (Interpreting the Statute)

Section 6231(a)(3) defines a partnership item as follows: ''with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.'' The item ''with respect to a partnership'' therefore must be (1) an item that must be taken into account for the partnership's tax year under any provision of subtitle A (income taxes); and (2) an item that the Treasury secretary has concluded is more appropriately determined at the partnership level than the partner level. The statute's seemingly innocuous language is not without controversy. Courts disagree over two central aspects of the provision.

One source of disagreement concerns the identity of the actor who must take into account the item for the partnership's tax year. Is the passive language of the statute referring to the partnership, the partner, or both? The unnamed subject of that phrase seems to only be the partnership, and the Tax Court has interpreted the language that way on multiple occasions.[17] Further, the corresponding definitional regulation for partnership items uses the following as a qualifying feature: ''to the extent that a determination of such items can be made from determinations that the *partnership is required to make*.''[18] But that authority was set aside in the Tax Court's recent opinion in *Tigers Eye Trading LLC v. Commissioner*.[19] One of the questions was whether a partner's outside basis in a partnership is a partnership item, so it can be determined in a partnership-level proceeding. In answering yes, the court implicitly concluded that the subject or actor referred to in the statute can also be the partner.[20] If there was any uncertainty, one of the concurrences clarified the issue by stating, ''We cannot exclude from the scope of section 6231(a)(3) the required account-taking actions of a taxpayer-partner.''[21] That reading of the statute broadens its reach. As one of the dissenting opinions notes, ''the majority construes [the first part of section 6231(a)(3)] to mean that an item only

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or suit under this subsection, the treatment of partnership items'' under the FPAA shall be conclusive.

[11]Sections 6221 through 6233. The Tax Court has referred to these procedures as ''distressingly complex and confusing.'' *Rhone-Poulenc Surfactants & Specialties LP v. Commissioner*, 114 T.C. 533, 540 (2000).

[12]H. Conf. Rept. 97-760, at 599-600 (1982); *Randell v. United States*, 64 F.3d 101, 103 (2d Cir. 1995).

[13]Penalties that relate to partnership items are also the proper subject of a partnership proceeding.

[14]Section 6231(a)(1)(A).

[15]Section 6231(a)(1)(B)(i).

[16]Section 6231(a)(1)(B)(ii).

[17]*See Hambrose Leasing 1984-5 LP v. Commissioner*, 99 T.C. 298 (1992) (examining the statutory definition of partnership item, the court held that the determination of an individual partner's amount at risk under section 465 for partnership liabilities was not a partnership item because it was not required to be taken into account by the partnership); *Dial USA Inc. v. Commissioner*, 95 T.C. 1 (1990) (under now-repealed procedural S corporation rules that incorporated by reference or largely mirrored the TEFRA partnership provisions, the court said, ''the critical element is that the corporation is required to make a determination''); *Olsen-Smith Ltd. v. Commissioner*, T.C. Memo. 2005-174 (the finding of a partnership item ''turns on whether the partnership is required to make a determination of that item''); and *Dakotah Hills Offices LP v. Commissioner*, T.C. Memo. 1996-35 (''the critical factor is whether the partnership was required to make a determination of that item'').

[18]Reg. section 301.6231(a)(3)-1(a)(4) (emphasis added).

[19]138 T.C. 67 (2012).

[20]*Id.* at 115-116. The Tax Court in *Tigers Eye* referenced two circuit court cases that seem to have reached the same conclusion, albeit with little analysis of the issue. *Id.* (quoting *Petaluma FX Partners LLC v. Commissioner*, 591 F.3d 649, 653 (D.C. Cir. 2010) (*Petaluma II*) (quoting *RJT Investments X v. Commissioner*, 491 F.3d 732, 736 (8th Cir. 2007))).

[21]*Tigers Eye*, 138 T.C. at 154.

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needs to be related to a partnership and 'taken into account in computing the income tax liability' of a partner.''[22]

The second area of controversy concerns what items are covered by the statute. Must an item be specified by the Treasury secretary in the regulations to be a partnership item? Must it be described in subtitle A? At least two circuit court opinions have rejected partnership item treatment for an item that was not specified in the regulations.[23] One of those opinions also noted that the item appears in subtitle F rather than subtitle A.[24] Both cases dealt with a partner's ability to request a settlement consistent with those offered to other partners. The partner-specific nature of that issue lends some logic to the courts' ultimate conclusions. Despite the language of the statute, another line of more recent cases has determined that the item need not be found in subtitle A or specified in the regulations.[25] The common feature of those cases is that the item and the particular facts were widely applicable to the partnership and all of the partners. In two of those cases, the courts also found the statutory language ambiguous, which triggered each to undertake a *Chevron* analysis. The courts therefore deferred to the broad language in the regulations and concluded that the items were partnership items.[26]

Comparing the earlier and more recent cases, one can understand the different outcomes based on the item at issue. But those varying results also demonstrate the inconsistency with which the circuits (internally in the case of the Federal Circuit) interpret the statutory language of the two requirements of section 6231(a)(3) described above. Although unsatisfying to the pure textualist, the takeaway seems to be that in determining whether something is a partnership item, the practitioner should focus on the issue's or item's effect on the partnership and the other partners.

B. Partnership Item (Interpreting the Regs)

Incorporating language similar to the statute's, reg. section 301.6231(a)(3)-1(a) specifies several partnership items, including the ''partnership aggregate and each partner's share of'' items of income, gain, loss, deduction, or credit of the partnership; guaranteed payments; optional basis adjustments under a section 754 election; and items related to contributions and distributions, to the extent exclusively determinable from other partnership items.

The Tax Court, perhaps expanding on the language of the statute and regulations (that is, the ''partnership aggregate and each partner's share''), has developed its own test for determining whether an item not identified in the regulation qualifies as a partnership item. In *Grigoraci v. Commissioner*, the court said, ''The hallmark of a partnership item is that it affects the distributive shares reported to the other partners.''[27] The court cited two earlier Tax Court cases in support of that rule, both of which focused on the effect on other partners.[28] The test has been cited with approval by other courts, most recently the Federal Circuit.[29]

The regulations also contain the so-called super-partnership item regulation, reg. section 301.6231(a)(3)-1(b) — so named because of the provision's broad scope: ''The term 'partnership item' includes the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc.'' The regulation also provides examples of partnership items, such as the partnership's accounting method, tax year, inventory method, partnership elections, asset characterization, and partnership profit motive.

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[22]*Id.* at 180.

[23]*See Prochorenko v. United States*, 243 F.3d 1359, 1363 (Fed. Cir. 2001) (the right to consistent settlement treatment among partners is not a partnership item); and *Monti v. United States*, 223 F.3d 76, 82 (2d Cir. 2000) (same).

[24]*Monti*, 223 F.3d at 82.

[25]*See Alpha I*, 682 F.3d 1009 (partner identity); *Petaluma II*, 591 F.3d 649 (validity or sham nature of a partnership); *Keener v. United States*, 551 F.3d 1358 (Fed. Cir. 2009) (partnership statute of limitations); *RJT Investments*, 491 F.3d 732 (legal validity of a partnership); and *Weiner v. United States*, 389 F.3d 152 (5th Cir. 2004) (partnership statute of limitations).

[26]*Alpha I*, 682 F.3d at 1020, n.3 (''we must give *Chevron* deference to regulations interpreting the interplay between the term 'partnership item' and the reference to Subtitle A of the tax code in Section 6231(a)(3)''); *Keener*, 551 F.3d at 1363 (citing *Chevron U.S.A. Inc. v. National Resources Defense Council Inc.*, 467 U.S. 837 (1984), in which the court said that ''since the statute is ambiguous with respect to this issue [*i.e.*, whether a provision outside of subtitle A can be a partnership item], we give deference to the agency's interpretation of the statute''). *See also Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011) (federal courts must defer to interpretive Treasury regulations that satisfy the two-step *Chevron* test).

[27]T.C. Memo. 2002-202, at *13. This test has a logical nexus to, and supports, multiple courts' interpretation of the first prong of the statute as being limited to those items ''required to be taken into account'' *by the partnership*. Only the partnership, not a partner, is involved with reporting distributive shares to the other partners.

[28]*Blonien v. Commissioner*, 118 T.C. 541, 551-552, n.6 (2002) (''resolution of the dispute could affect the partnership allocations to the other partners''); *Katz v. Commissioner*, 116 T.C. 5, 12 (2001), *rev'd*, 335 F.3d 1121 (10th Cir. 2003).

[29]*Alpha I*, 682 F.3d at 1023 (''the trial court was correct to rely on the general rule set forth in *Grigoraci*'').

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Some practitioners — both inside and outside the government — believe that the super-partnership item regulation can be used to shoehorn almost anything into the partnership item classification. Some of the above-referenced circuit opinions holding that items were partnership items relied on the super-partnership item regulation, even though the item was not specified in subtitle A or the regulations.[30] But one of the courts rejected that argument.[31]

C. Other Definitions

Under TEFRA, affected items, computational adjustments, and non-partnership items are defined, to varying degrees, in relation to the term ''partnership item.'' The IRS uses procedural devices other than an FPAA to adjust those items. For example, upon the completion of a partnership proceeding and depending on the type of item, the IRS may issue a partner an affected items notice of deficiency, which allows the partner to initiate a proceeding in Tax Court to challenge a proposed adjustment to an affected item.[32]

An affected item is defined as ''any item to the extent such item is affected by a partnership item,'' but it also includes ''items unrelated to the items reflected on the partnership return.''[33] That definition from both the statute and the regulations suggests a relatively broad coverage. For example, it may include a determination of the amount of a partnership loss recognized by a partner because of his outside basis or at-risk limitation. It would also include the threshold for the medical expense deduction under section 213, which varies if there is a change in an individual partner's adjusted gross income.[34] The regulations also identify some items that are affected items ''to the extent they are not partnership items,'' such as a partner's outside basis in the partnership, the section 465 at-risk limitation for partnership losses, and the passive loss limitation under section 469 for partnership losses.[35] The term ''affected item'' also includes penalties, as described in the regulations.[36]

At the conclusion of a partnership proceeding, the IRS will issue an affected items notice of deficiency for items that require partner-level determinations.[37] For items that do not, the IRS issues a notice informing the partner that it has made a computational adjustment, which is directly assessed without the benefit of the deficiency procedures — that is, without the ability to litigate in Tax Court.[38] The code defines a computational adjustment as ''the change in the tax liability of a partner which properly reflects the treatment . . . of a partnership item.''[39]

The code defines a non-partnership item rather circularly: ''an item which is (or is treated as) not a partnership item.''[40] Unfortunately, the regulations do not further define the term. And the statutory language includes not only items that are unrelated to a partnership (for example, a partner's gain on the sale of corporate stock), but also affected items.

II. Areas of Expansion

Over the last several years, the IRS and the courts have through litigation been slowly expanding the reach of the partnership item categorization and, implicitly, the IRS's authority to pursue items that may not deserve that classification in a partnership proceeding. Although this methodical push has occurred in multiple areas, three in particular have been the subject of recent litigation: partner identity, sale or transfer of a partnership interest, and a partner's outside basis in his partnership interest.

A. Partner Identity

Partner identity is one of those items that can have differing classifications depending on the facts and circumstances. The standard applied by the Tax Court and recently affirmed by the Federal Circuit is that a partner's identity constitutes a partnership item under section 6231(a)(3) when it affects the distributive shares of the other partners.[41] Although

[30]*Petaluma II*, 591 F.3d at 653-654 (validity or sham nature of a partnership); *Keener*, 551 F.3d at 1363 (partnership statute of limitations); *RJT Investments*, 491 F.3d at 737 (legal validity of a partnership); *Weiner*, 389 F.3d at 157 (partnership statute of limitations).

[31]*Alpha I*, 682 F.3d at 1026, n.7 (partner identity).

[32]Section 6230(a)(2)(A)(i).

[33]Section 6231(a)(5); reg. section 301.6231(a)(5)-1(a). The Tax Court, in an attempt to further define the term, has said that ''an affected item, rather than being universally applicable to every partner, is peculiar to a particular partner's tax posture.'' *Ginsburg v. Commissioner*, 127 T.C. 75 (2006) (citing *Maxwell v. Commissioner*, 87 T.C. 783, 790 (1986)).

[34]Reg. section 301.6231(a)(5)-1(a).

[35]Reg. section 301.6231(a)(5)-1(b), (c), and (d).

[36]Reg. section 301.6231(a)(5)-1(e).

[37]Section 6230(a)(2)(A)(i).

[38]Reg. section 301.6231(a)(6)-1(a)(1).

[39]Section 6231(a)(6). The regulations define a computational adjustment as ''a change in tax liability that reflects a change in an affected item where that change is necessary to properly reflect the treatment of a partnership item.'' Reg. section 301.6231(a)(6)-1(a)(1). The term also includes ''changes in a partner's tax liability with respect to affected items.'' Reg. section 301.6231(a)(6)-1(a)(2) and (3).

[40]Section 6231(a)(4).

[41]*See Alpha I*, 682 F.3d at 1022-1023 (citing with approval the general rule enunciated by the Tax Court that ''the inquiry turns on the facts of the particular case and the effect that partner identity would have on the distributive shares''); *Blonien*, 118 T.C. at 551 (''to the extent that the taxpayer's claim that he was

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the standard seems relatively clear, courts have applied it differently, as demonstrated by the cases discussed below.

1. Government approach. The IRS seems to recognize that there is uncertainty in this area, but that has not stopped it from continuing to pursue its position that partner identity is always a partnership item. The Office of Chief Counsel has advised IRS personnel that partner identification is a partnership item to be determined at the partnership level.[42] As its justification, chief counsel asserts that ''even if the court determines that the issue must be resolved at the partner level, section 6229(d) will likely suspend the statute of limitations.''[43] In other words, even if partner identity may not be a partnership item based on the facts of a particular case, the IRS should argue the contrary because even if it is unsuccessful at the partnership level, it will likely be able to make another attempt during a partner-level proceeding. Although this may be a sound strategic approach, even chief counsel, by noting that ''duplicative protective nonpartnership procedures may be necessary in some circumstances,'' recognizes that it is not necessarily consistent with TEFRA's goal of greater efficiency.[44]

2. *Blonien* (Tax Court). One of the Tax Court's earliest resolutions of this issue came in *Blonien v. Commissioner*, a partner-level proceeding in which the Tax Court confronted the question of whether it had jurisdiction over the identity of the partners of a partnership.[45] Rodney Blonien asserted that he was not a partner subject to assessment for affected items. The court reasoned that the inclusion or non-inclusion of Blonien in the partnership would affect the other partners' distributive shares and thus determined that partner identity was a partnership item under the facts. The court held that it had no jurisdiction to determine partner identity because it was bound by the determination in the partnership proceeding that Blonien was a partner. As the Tax Court in *Blonien* recognized, the partner identity question can arise in different contexts with differing outcomes, for example, the inclusion or non-inclusion of a partner in a partnership, and the determination of partner identity as between an individual and his corporation.[46]

3. *Katz* (Tax Court and Tenth Circuit). Relying on principles similar to those in *Blonien*, the Tax Court reached the opposite conclusion regarding partner identity in *Katz v. Commissioner*.[47] In a partner-level proceeding, the partner filed a motion to dismiss, asserting that the court lacked jurisdiction to determine partner identity as between the individual and his bankruptcy estate because that determination is a partnership item. The court concluded that an allocation of partnership items between those two related but independently taxed entities would have no effect on the remaining partners or their distributive shares. It therefore held that in that context, partner identity is not a partnership item. On appeal, a divided Tenth Circuit panel reversed, holding that the allocation of partnership items (in this case net operating losses) between an individual partner and his bankruptcy estate — that is, determining the identity of the correct partner — is a partnership item.[48] The dissent said the majority misunderstood the nature of the issue, as reflected in its improper assumption that the partnership would have to make allocations between the partner and the bankruptcy estate.[49] The dissent explained that that type of allocation is not something the partnership would be required to do, and it is thus not a partnership item.[50]

4. *Grigoraci* (Tax Court). In *Grigoraci*, another Tax Court case with facts similar to those in *Katz* — that is, whether an individual or a third party was the true partner — the court held that partner identity (or beneficial ownership) is not a partnership item.[51] Applying the reasoning of *Blonien*, the court determined that whether the corporations that were the partners of record or their individual sole shareholders were the partners would not affect the partnership's aggregate or the partners' distributive shares of income or loss.[52] Although the *Grigoraci*

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not a partner would affect the distributive shares of the other partners, the taxpayer's claim was a partnership item''); and *Grigoraci*, T.C. Memo. 2002-202, at *13 (examining partner identity, the court said that ''the hallmark of a partnership item is that it affects the distributive shares reported to the other partners'').

[42]CC-2009-027, at 14-15 (''In light of this uncertainty, the IRS should determine the identities of partners at the partnership level'').

[43]*Id.*

[44]*Id.*

[45]118 T.C. 541 (2002).

[46]*Id.* at 552, n.6 (''We recognize that the determination of who is a partner can be a partner-level item where resolution of the issue would not affect the allocation of partnership items to the other partners'').

[47]116 T.C. 5.

[48]335 F.3d at 1125.

[49]*Id.* at 1128-1129.

[50]*Id.* at 1129 (''The dispute between Taxpayer and the bankruptcy estate about their rights to claim the net operating loss carryovers in 1991-1994 is not an item that was required to be taken into account by the partnership, either in 1990, the year in which the partnership sustained the loss, or in the subsequent years 1991-1994'').

[51]T.C. Memo. 2002-202.

[52]*Id.* at *15 and *18 (''reallocation of the distributive share of any corporate partner of record to the individual who owns

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court applied the same legal standard and reasoning as the *Blonien* court, the former reached the opposite result. Recall that in *Blonien*, the court addressed whether one individual was a partner in a partnership, thereby potentially affecting the other partners' distributive shares, while in *Grigoraci*, the overall number of partners was not at issue.

5. *Alpha I LP* (Court of Federal Claims and Federal Circuit). The Federal Circuit in *Alpha I LP v. United States*, faced with facts similar to those in *Grigoraci*, applied the same test but held that partner identity is a partnership item.[53] In *Alpha I*, four partners transferred their partnership interests to their charitable remainder unitrusts (CRUTs) over the course of the tax year. The IRS attempted through an FPAA to sham those transfers and treat the transferring partners as the true partners. After initiating the partnership proceeding, the transferring partners filed a motion to dismiss that determination by the IRS, arguing that the court lacked jurisdiction under section 6226(f) because partner identity is not a partnership item. The Court of Federal Claims granted the motion to dismiss. Quoting from *Grigoraci*, it said, ''Where there is . . . no dispute about the amount of the allocations made to the partners,'' the determination of the identity of a partner is more appropriately made at the partner level.[54] The Federal Circuit, while citing with approval the lower court's reliance on *Grigoraci*, reversed and said the Court of Federal Claims had incorrectly applied the test.[55] The appellate court focused on the fact that if the CRUTs were disregarded, the partners' distributive shares would be affected.[56] The Federal Circuit's potential concern seemed to be that partnership allocations would be between eight or four partners depending on the court's determination of the partners' identity. In that respect, the court viewed the facts of *Alpha I* as more akin to those of *Blonien*, that is, the total number of partners was at issue, as opposed to one person or entity being chosen as the true partner.

The partnership attempted to counter that if the transfers to the CRUTs were in fact shams, the allocations among the partners would not change, and the partners would simply stand in the shoes of the CRUTs.[57] The partnership's argument is that the issue is the identity of the true partner, as opposed to the inclusion or non-inclusion of a particular partner. The partnership thus attempted to liken the facts to those of *Grigoraci*. The Federal Circuit, after noting that the IRS proposed allocations in the manner described by the partnership, rejected that view by stating that the Service's proposal did not deprive the Court of Federal Claims of jurisdiction.[58] The partnership has since filed a petition for writ of certiorari with the Supreme Court.[59]

The Federal Circuit in *Alpha I* also used language that could foreshadow a new perspective on whether partner identity is a partnership item. The court said that because a partnership is required to file an informational return, there is a close relationship between allocation and partner identity, and the return requirement mandates that a partnership's information return identify the partners.[60] Although the court seemed to be using that language in a prefatory manner, it could signal a shift. The analysis would seem to be that because the identity of the partner must be accurately included on the partnership's return, for example, on Forms K-1 that are filed as part of Form 1065, partner identity is always a partnership item. The broad reach of this view may produce different outcomes when the issue is the identity of the true partner, for example, as between an individual and his sole corporation.

6. *Hang* (Tax Court). Another relevant case is *Hang v. Commissioner*,[61] in which the Tax Court, analyzing now-repealed code sections that applied the TEFRA provisions to S corporations, determined that shareholder identity was not a subchapter S item, which was similar to a partnership item. The IRS issued an FPAA-equivalent to the S corporation, reallocating income from the two shareholders of record to their father, William Hang, asserting that he was the true beneficial shareholder. After initiating the S corporation-level proceeding, the S corporation and shareholders moved to dismiss, arguing that the court lacked jurisdiction over the issue of shareholder identity. The court granted the motion, holding that it lacked jurisdiction to determine the true beneficial shareholder as between a father and his two sons. After noting that jurisdiction over shareholder identity is not explicitly within its statutory and regulatory authority on the *Hang* facts, and that

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such Corporation has no impact on the other partners' shares of income, gain, loss, deductions, or credits'').

[53] 682 F.3d 1009.

[54] 84 Fed. Cl. at 221.

[55] 682 F.3d at 1023 (''While the trial court was correct to rely on the general rule set forth in *Grigoraci*,'' its application of the facts to that rule was erroneous).

[56] *Id.* at 1024 (''The fact that the distributive shares could be affected by the determination of the partners' identity is sufficient to sweep the issue within the definition of a partnership item'').

[57] *Id.* (''The taxpayers next argue that the allocation among them will not change regardless of the identity of the [partnership's] true partners'').

[58] *Id.*

[59] *See supra* note 8.

[60] 682 F.3d at 1021.

[61] 95 T.C. 74 (1990).

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beneficial ownership (as opposed to mere legal title) is the decisive inquiry for determining shareholder identity, the court found that the information necessary to make the determination was unavailable to the corporation and that the inquiry was more appropriately made at the shareholder level than the corporate level. The Tax Court identified a four-factor test from the Seventh Circuit that is used to decide shareholder status in a subchapter S corporation when stock was transferred between family members.[62] It noted that the test ''emphasizes what the shareholders or former shareholders did, or what their rights are, and not what happened at the corporate level.''[63]

Hang was decided more than 10 years before the more recent cases, but it is still interesting for a few reasons. Because of the facts, the court quickly moved past the equivalent of the distributive shares test that would later be articulated in *Grigoraci*. The court said the shareholder identity question was not expressly within its jurisdiction because the father was not a shareholder of record, so allocations between him and his sons (shareholders of record) would not be covered by the language of the regulation.

Although both the *Grigoraci* and *Blonien* courts cited *Hang* with approval to support the outcome on their particular facts, *Hang* includes factual elements like those of both cases. In *Hang*, the question of identity was between a father and each son, which is similar to that in *Grigoraci* (between each corporation and its sole shareholder), in which the court determined that partner identity is not a partnership item. But the total number of shareholders would be affected depending on the identity of the shareholder(s), that is, just the father or his two sons, which is similar to the question in *Blonien* (whether an individual was a partner), in which the court determined that partner identity is a partnership item.[64] However, the *Blonien* court distinguished the *Hang* facts by noting that resolution of the dispute would not affect the original allocations to or distributive shares of the shareholders.[65]

The trial and appellate courts in *Alpha I* disagreed over the utility of *Hang*. The Court of Federal Claims relied on *Hang* to support its holding that partner identity is not a partnership item because the ''partnership is not in a position to go behind the transactions between a partner and its successor of record.''[66] However, the Federal Circuit rejected that reasoning by distinguishing *Hang*, saying that because the father in *Hang* was not a shareholder of record, there was no authority in the regulations to allocate items between him and his sons.[67] The court of appeals also noted in *Alpha I* that all of the potential partners were partners of record, the allocations between them were expressly within the court's jurisdiction, and if the CRUTs were not partners, the allocations to the other partners would be affected.[68]

As the foregoing cases reveal, the question of whether partner identity is a partnership item is fact-specific and can have varying outcomes depending on the context in which a court is asked to make the determination. The one constant point of reference is the test articulated by the Tax Court in *Grigoraci* (relying on the regulation), which is consistent with TEFRA's goals of uniformity and efficiency: Partner identity is a partnership item when it has an ''effect on the partnership's aggregate or each partner's [distributive] share of income, gain, loss, deductions or credits.''[69]

B. Sale or Transfer of a Partnership Interest

Another area of potential partnership item treatment concerns the sale or transfer of a partnership interest, which also hinges on the underlying facts. The transfer of a partnership interest generally does not affect the partnership or the other partners, and it should thus not be classified as a partnership item. However, there are scenarios identified in the case law, regulations, and the Internal Revenue Manual that can bring this issue within the ambit of the partnership item designation.

1. *Regents Park Partners* (Tax Court). One of the earliest cases that confronted the issue was *Regents Park Partners v. Commissioner*, in which the Tax Court determined in a partnership proceeding that it lacked jurisdiction over determinations regarding the transfer of a partnership interest.[70] Through FPAA, the IRS sought to prospectively adjust the

[62]*Id.* at 80-81 (citing *Speca v. Commissioner*, 630 F.2d 554, 556 (7th Cir. 1980)).

[63]*Hang*, 95 T.C. at 80-81.

[64]One could understand, however, that if a court were faced with the *Hang* facts in the partnership context and there were no other partners, it would determine partner identity to be a partnership item, because whether there are two partners or one partner would have a direct effect on the validity of the partnership: A partnership must have at least two partners to be so classified.

[65]*Blonien*, 118 T.C. at 551, n.6.

[66]*Alpha I*, 682 F.3d at 1023-1024.

[67]*Id.* at 1024.

[68]*Id.* (''The fact that the distributive shares could be affected by the determination of the partners' identity is sufficient to sweep the issue within the definition of a partnership item, because the effect on the distributive shares is the 'hallmark' of a partnership item'').

[69]*Grigoraci*, T.C. Memo. 2002-202, at *18.

[70]T.C. Memo. 1992-336.

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character of the gain to be recognized on a partner's sale of a partnership interest. Despite that, the court went on to analyze the relevant issue. After referring to the statute and the regulations, the court said ''the regulations do not provide that the character of the gain from the sale of a partner's interest in the partnership is an item more appropriately determined at the partnership level, nor does it appear to be an item that a partnership is required to take into account for its taxable year.''[71] Although the court focused on the somewhat narrow question of the character of the gain to be recognized, the reasoning seems to apply generally to almost all determinations associated with the sale or transfer of a partnership interest.

2. Section 754 election. The regulations specify only one exception to the general rule that attributes of a transfer or sale of a partnership interest are partnership items: when the partnership has made an election under section 754. Section 754, along with section 743, requires the partnership to make adjustments to the inside bases of its assets to create parity with the transferee partner's outside basis in the partnership.[72] The partnership item regulation includes ''optional basis adjustments to the basis of partnership property pursuant to an election under section 754 (including necessary preliminary determinations, such as the determination of a transferee partner's basis in a partnership interest).''[73]

When there is no section 754 election, the authorities have consistently found that the sale or transfer of a partnership interest is not a partnership item. In a different subsection, the partnership item regulation says that without a section 754 election, ''the amount that the partner paid to acquire the partnership interest from a transferor partner'' is not a partnership item.[74] Although reversed on other grounds, the Court of Federal Claims said in *Alpha I* that ''absent a section 754 election . . . the transfer of a partnership interest is not a partnership item.''[75] The IRS also recognizes that the purchase of a partnership interest, including the amount paid, should not be determined at the partnership level when the partnership has not made a section 754 election.[76]

3. *Alpha I* (Court of Federal Claims and Federal Circuit). The Federal Circuit in its reversal in *Alpha I* did not address the lower court's analysis of the transfer of a partnership interest. Recall that the case involved four partners transferring their partnership interests to their CRUTs, and the FPAA asserted that the transfers should be disregarded as shams.[77] The Federal Circuit, however, saw the question as one of partner identity.[78]

Despite the close relationship between partner identity and the sale or transfer of a partnership interest, the two items are distinct and should be analyzed as such. Determining which item a practitioner encounters will depend on the nature of the IRS's proposed adjustment. If the IRS seeks to challenge the validity of a transfer, it is more likely that partner identity will be implicated, and in that context it is a partnership item. However, if the IRS attempts to adjust an effect of a transfer, for example, gain on the sale of an interest or the amount paid for an interest, partner identity should not be implicated and the adjustment should be to a non-partnership item.

C. Outside Basis

Until two recent Tax Court decisions,[79] courts were uniform in the view that outside basis in a partnership interest is not a partnership item, but an affected item.[80] Indeed, there is a regulation on point that states, ''The basis of a partner's partnership interest is an affected item to the extent it is not a partnership item.''[81] And there is one explicit, limited instance in the regulations in which outside

[71]*Id.* at *73.

[72]Section 743(b).

[73]Reg. section 301.6231(a)(3)-1(a)(3).

[74]Reg. section 301.6231(a)(3)-1(c)(3).

[75]*Alpha I*, 84 Fed. Cl. at 219.

[76]IRM section 4.31.2.2.12.1(2) (''A partner level component . . . occurs when a partner buys his partnership interest from another partner (and it's not subject to an IRC 754 election)''); IRM section 8.19.1.6.9.4(2)(f) (''Issues at the partner level include the cost to purchase the partnership interest (if no IRC 754 election is made by the partnership for such cost)'').

[77]*Alpha I*, 682 F.3d at 1017.

[78]*Id.* at 1018 (''In determining whether the transfers were shams, the Court of Federal Claims was asked to determine the identity of the true partners'').

[79]*Tigers Eye*, 138 T.C. 67; *Petaluma*, 131 T.C. 84 (2008) (*Petaluma I*). Also of note is the Tax Court's decision in *Thompson v. Commissioner*, 137 T.C. 220 (2011), in which the court in a partner-level proceeding referred to its prior determination in the related partnership proceeding that outside basis is a partnership item. *Id.* at 236, *rev'd on other grounds*, No. 12-1725 (8th Cir. 2013).

[80]*Jade Trading LLC v. United States*, 598 F.3d 1372 (Fed. Cir. 2010); *Schell v. United States*, 589 F.3d 1378, 1382 (Fed. Cir. 2009); *Meruelo v. Commissioner*, 132 T.C. 355, 367 (2009), *aff'd*, 691 F.3d 1108 (9th Cir. 2012); *Domulewicz v. Commissioner*, 129 T.C. 11, 21, n.13 (2007), *aff'd in part and remanded on other grounds sub nom.*, *Desmet v. Commissioner*, 581 F.3d 297 (6th Cir. 2009); *G-5 Investment Partnership v. Commissioner*, 128 T.C. 186, 189, n.7 (2007); *Ginsburg*, 127 T.C. 75; *Dial USA*, 95 T.C. 1, 5-6; *Gustin v. Commissioner*, T.C. Memo. 2002-64, *15. *Cf. Countryside LP v. Commissioner*, T.C. Memo. 2008-3, at *12, n.4.

[81]Reg. section 301.6231(a)(5)-1(b).

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basis is a partnership item.[82] As ostensibly recognized by the regulation, outside basis has a duality. It is determined not only by partnership items such as income, gain, deductions, and losses, but also by non-partnership items such as the amount a partner paid for his interest.[83] Outside basis is not typically something that the partnership is required to take into account or that is more appropriately determined at the partnership level, so it is removed from the general purview of the statute and the regulation.[84]

1. Government approach. The IRS generally follows that approach. The direction provided to IRS examination agents in the IRM is that for outside basis, ''case law has indicated that these overall determinations will always be affected item determinations.''[85] A different section of the IRM explains to Appeals officers that a partner's outside basis is generally composed of both partnership and non-partnership items, which may suggest that ''an initial determination [should be] made at the partnership level, with additional factual development required at the partner level.''[86] That language also seems to recognize that outside basis overall is an affected item. But the IRM also says outside basis is an issue to be determined at the partnership level, that is, it's a partnership item when the partnership is disregarded for tax purposes.[87] That portion of the IRM was amended in February 2009, apparently in response to the Tax Court's decision in *Petaluma I*.[88] Before the decision, the Appeals-related portion of the manual did not include the disregarded partnership exception.[89]

The Office of Chief Counsel also takes the position that a partner's outside basis is made up of both partnership- and partner-level determinations.[90] Although not explicitly, chief counsel agrees that overall a partner's outside basis is not a partnership item. As further support for that proposition, one need only look to the two recent Tax Court decisions in *Petaluma I* and *Tigers Eye*, cases in which the government conceded that outside basis is generally not a partnership item.[91] Chief counsel has designated outside basis as a partnership item only when that determination is made in conjunction with the IRS shamming the partnership.[92] In support of that assertion, chief counsel relies on *Petaluma I* and notes that the sham determination includes the basis determination.[93] However, *Petaluma I* was reversed on appeal.[94]

2. *Petaluma* (Tax Court and D.C. Circuit). A partnership generally is not required to take into account or make a determination of a partner's outside basis in a partnership. As described in *Petaluma I*, the Tax Court in a partnership proceeding shammed the partnership and then determined that each partner's outside basis was necessarily zero.[95] Interestingly, the Tax Court appears to have broken from its own precedent, even though it cited that precedent in its analysis. The court said that in

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[82]Reg. section 301.6231(a)(3)-1(a)(3) lists ''a transferee partner's basis in a partnership interest'' when a partnership has made a section 754 election.

[83]*Dial USA*, 95 T.C. at 4, n.4 (the purchase price of a partner's partnership interest is not required to be taken into account by a partnership for its tax year).

[84]Section 6231(a)(3) and reg. section 301.6231(a)(3)-(a). *Petaluma II*, 591 F.3d 649 (no indication that outside basis is more appropriately determined at the partnership level); *Dial USA*, 95 T.C. at 5-6 (1990) (the critical factor is whether the entity is required to make the determination). *But see* the Tax Court's recent decision in *Tigers Eye*, which rejects this approach when the court has shammed the partnership; the court determined that outside basis is a partnership item when it can be determined solely from other partnership items. *Tigers Eye*, 138 T.C. at 126.

[85]IRM section 4.31.2.2.12(6). At subsection (7), it provides examples of the different partnership- and partner-level items that make up the overall outside basis determination of a partner.

[86]IRM section 8.19.1.6.9.4(2)(f).

[87]*Id.*

[88]In *Petaluma I*, the Tax Court determined, after shamming a partnership, that the partners' outside bases were partnership items subject to the court's jurisdiction in a partnership proceeding. 131 T.C. at 101.

[89]IRM section 8.19.1.6.9.4(2)(f).

[90]CC-2009-027, at *4-*6.

[91]*Petaluma I*, 131 T.C. at 98 (''Respondent acknowledges that as a general matter the Court lacks jurisdiction in a partnership-level proceeding to calculate outside basis''); *Tigers Eye*, 138 T.C. at 74-76 (''respondent made the same concession as the government made in *Petaluma II*'' that outside basis is an affected item). In *Petaluma II*, the government conceded that outside basis is an affected item but argued that in the context of an invalidated partnership, the court had jurisdiction to determine that item in a partnership proceeding. *Petaluma II*, 591 F.3d at 654.

[92]CC-2009-027 at *5-6 (''There would be no partner-level factual determinations left to be made to calculate outside basis because, as a matter of law, there can be no basis in a nonexistent partnership'').

[93]*Id.*

[94]*Petaluma II*, 591 F.3d at 655 (''The fact that a determination seems obvious or easy does not expand the court's jurisdiction beyond what the statute provides. In other words, it does not matter how low the fruit hangs when one is forbidden to pick it'').

[95]*Petaluma I*, 131 T.C. at 101 (''The Court will not turn a blind eye to the fact that a partner has no outside basis when this is a conclusion that stems directly from the Court's determination that a partnership or a partner's participation in the partnership should be disregarded'').

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determining whether outside basis is a partnership item, ''the critical factor is whether the item is required to be taken into account by the *partnership*.''[96] The court then turned to a regulatory provision as support for its authority to determine the partners' outside bases in a partnership proceeding,[97] but it never reconciled its position with the language of the statute — that is, what ''required'' the partnership to take its partners' outside bases into account — or its own precedent.[98] The Tax Court also applied a 40 percent accuracy-related penalty to the ''overstatement'' of the partners' outside bases.[99]

On appeal in *Petaluma II*, the D.C. Circuit reversed the lower court's determination that outside basis is a partnership item. Even though the consequences of shamming the partnership would necessarily lead to zero bases for the partners, the appellate court found that the Tax Court had no jurisdiction to make that determination. The D.C. Circuit noted, ''It does not matter how low the fruit hangs when one is forbidden to pick it.''[100] It said that ''nothing about the concept of outside basis indicates that it is more appropriately determined at the partnership level,'' thereby addressing the second prong of the partnership item statute.[101] The D.C. Circuit also reversed and remanded the Tax Court's decision to apply penalties to the partners' outside bases.[102]

Unfortunately, the *Petaluma II* court did not analyze in its discussion on outside basis whether that item is something the partnership is ''required to take into account for the partnership's taxable year,'' which would have addressed the first prong of the partnership item statute and the unexplained portion of the *Petaluma I* decision described above. However, in considering whether shamming the partnership is a partnership item, the *Petaluma II* decision referred to the first prong. The court discussed the language ''required to be taken into account . . . under any provision of subtitle A'' and referred to an individual taxpayer-partner,[103] but it did not analyze whether the first prong of the statute limits the required account-taking to the partnership or extends it to the partner. As detailed below, this limited discussion from *Petaluma II* became an important linchpin in the Tax Court's decision in *Tigers Eye*.

3. *Tigers Eye* (Tax Court, and soon to be decided by the D.C. Circuit). The Tax Court's follow-up decision to *Petaluma I* was *Tigers Eye*, a partnership proceeding in which the court invalidated the partnership, as in *Petaluma I*, and determined that it had jurisdiction to determine that the partners' outside bases were zero.[104] The court also upheld a 40 percent accuracy-related penalty resulting from an overstatement of basis in capital contributions.[105]

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[96]*Petaluma I*, 131 T.C. at 98-99 (emphasis added) (citing *Dakotah Hills*, T.C. Memo. 1996-35; *Olsen-Smith*, T.C. Memo. 2005-174; *Dial*, 95 T.C. 1).

[97]The court relied on reg. section 301.6231(a)(3)-1(c)(2) and (3), which generally provide that partnership items include determinations that relate to contributions and distributions to the extent that those determinations do not require information unrelated to partnership items. Reasoning that outside bases in a shammed partnership required only partnership-level determinations, the court held that it had jurisdiction to determine that the partners' outside bases were zero. *Petaluma I*, 131 T.C. at 100-101. In reaching that determination, the court failed to take note of the prefatory language of the same regulation, which states that ''the critical element is that the partnership needs to make a determination with respect to a matter for the purposes stated.'' Reg. section 301.6231(a)(3)-1(c)(1). As described above, the court never reconciled its position with the fact that partnerships are not required to make a determination of partners' outside bases, except in limited circumstances not applicable in *Petaluma I*.

[98]*Petaluma I*, 131 T.C. at 99 (citing reg. section 301.6231(a)(3)-1(c)(2) and (3), the court summarily said, ''The regulations indicate that in a situation where no partner-level determinations are necessary to determine outside basis, this determination may be a partnership item'').

[99]*Id.* at 103.

[100]*Petaluma II*, 591 F.3d at 655.

[101]*Id.*

[102]*Id.* The appellate court agreed with the partnership's assertion that ''since the Tax Court lacked jurisdiction to determine outside basis, it also lacks jurisdiction to determine that penalties apply with respect to outside basis because those penalties do not relate to an adjustment to a partnership item.'' The remand to the Tax Court was for a determination of whether there was any other basis on which to determine the existence of a penalty at the partnership level. On remand, the Tax Court, relying on language of the D.C. Circuit, determined that there are no adjustments in the FPAA on which a penalty was applicable that could be '''computed without partner-level proceedings.''' *Petaluma FX Partners LLC v. Commissioner*, 135 T.C. 581, 586-587 (2010) (*Petaluma III*) (quoting from *Petaluma II*). Thus, the lower court held that it had no jurisdiction over the section 6662 penalty determinations. The government has since appealed the Tax Court's holding in *Petaluma III* to the D.C. Circuit to determine the scope of the phrase ''relates to an adjustment to a partnership item'' as that term is used in section 6226(f) to define the court's jurisdiction over penalties in a partnership proceeding. *Appeal docketed*, No. 12-1364 (D.C. Cir. Apr. 22, 2012).

[103]*Petaluma II*, 591 F.3d at 653. The court quoted the Eighth Circuit's opinion in *RJT Investments*, 491 F.3d at 736, which similarly held that shamming a partnership is a partnership item. But the Eighth Circuit's analysis assumes that the first prong of the partnership item statute refers to a partner, without any analysis of that point or discussion of the previously cited Tax Court decisions that limit the required account-taking to that of the partnership. *Id.*

[104]*Tigers Eye*, 138 T.C. 67.

[105]*Id.* at 143. The Tax Court said that the penalty is based on the ''distributed property loss deficiency attributable to overstating capital contributions.'' Noting that the partners would take a basis in the distributed property equal to the ''purported'' partnership's cost basis as a nominee, the Tax Court held that

(Footnote continued on next page.)

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The majority's 126-page opinion made many determinations and was followed by multiple written concurrences and dissents totaling approximately 85 pages. The partnership and one of its partners brought the matter before the court on a motion to revise a stipulated decision document in which the parties stipulated that outside bases in the partnership were zero. The basis for the motion was the then-recent D.C. Circuit holding in *Petaluma II* that a court does not have jurisdiction to determine the partners' outside bases in a partnership proceeding.[106]

As the Tax Court noted, *Tigers Eye* is appealable to the D.C. Circuit, the same court that decided *Petaluma II*.[107] The *Tigers Eye* court rejected the notion that it was bound by *Petaluma II* because the Tax Court determined that the appellate court did not analyze the outside basis question in the context of the regulations, but merely accepted the government's concession that outside basis is an affected item.[108] The *Tigers Eye* court determined that the Supreme Court's intervening opinion in *Mayo Foundation for Medical Education and Research v. United States*[109] (regarding deference to Treasury regulations), as well as the D.C. Circuit's decision in *Intermountain v. Commissioner*[110] (which was later vacated by the Supreme Court) meant that the *Petaluma II* decision was not binding precedent.[111]

Applying a two-step *Chevron* analysis (as required by *Mayo*), the Tax Court first examined the partnership item statute. Seemingly finding it ambiguous, the Tax Court said, ''Congress has not excluded the partners' outside bases from the definition of partnership item.''[112] The court then determined that deference to a reasonable statutory interpretation in the regulations would be appropriate.[113] It found that reasonable interpretation in reg. section 301.6231(a)(3)-1(c)(3), a provision that treats items related to distributions from a partnership, such as the amount of money distributed to a partner, as partnership items.[114] The regulation also says that other items related to distributions are partnership items if they can be determined from ''determinations that the partnership is required to make.''[115] However, if other non-partnership items are needed to make that determination, the item is not a partnership item.[116] Applying this regulation, the Tax Court reasoned that in a partnership that is deemed not to exist, outside basis can be determined solely through partnership items and, thus, is itself a partnership item.[117] The court said that ''no additional facts are required to determine a zero outside basis, and no additional facts could possibly alter that conclusion.''[118]

The *Tigers Eye* court addressed the partnership item statute, starting with the first prong, in which it assumed that the required account-taking for a partnership's tax year includes as the subject not only the partnership but also the partner. In support of that assumption, the Tax Court quoted *Petaluma II*, including its cite to the Eighth Circuit's decision in *RJT Investments*, neither of which analyzed the statute to determine if it includes the partner as the one doing the required account-taking.[119] One of the concurrences reaffirms the majority by stating, ''We cannot exclude from the scope of section 6231(a)(3) the required account-taking actions of a taxpayer-partner.''[120] But that reading of the statute will undoubtedly expand its reach, as one of the dissenting opinions asserts: ''The majority construes [the statutory language] to mean that an item only needs to be related to a partnership and 'taken into account in computing the income tax liability' of a partner.''[121]

Unfortunately, as with the D.C. Circuit's decision in *Petaluma II*, the majority did not provide an analysis of the first prong of the partnership item statute, although it did attempt to distinguish a few of its own contrary precedents that limited the reach of the statute to items required to be taken into

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the language of section 6226(f) (*i.e.*, jurisdiction over any penalty that ''relates to an adjustment to a partnership item'') meant that it had jurisdiction over the 40 percent penalty. As with *Petaluma*, the scope of the phrase ''relates to an adjustment to a partnership item'' is at the center of the current dispute on appeal. *Appeal docketed*, No. 12-1148 (D.C. Cir. Mar. 16, 2012).

[106] *Tigers Eye*, 138 T.C. at 109-110.

[107] *Id.* at 74, n.8.

[108] *Id.* at 75-76 (''Because the Court of Appeals [in *Petaluma II*] did not consider the precise issue we decide herein, *Golsen* does not apply''). Interestingly, the government in *Tigers Eye* made a similar concession that outside basis is an affected item, but the Tax Court decided to ''reject respondent's concession.'' *Id.*

[109] 131 S. Ct. 704.

[110] 650 F.3d 691 (D.C. Cir. 2011), *vacated and remanded*, 132 S. Ct. 2120 (2012).

[111] *Tigers Eye*, 138 T.C. at 109-110.

[112] *Id.* at 124.

[113] *Id.*

[114] *Id.* at 126-128.

[115] Reg. section 301.6231(a)(3)-1(c)(3).

[116] *Id.*

[117] *Tigers Eye*, 138 T.C. at 127-128. As stated above, the court relied on reg. section 301.6231(a)(3)-1(c)(2) and (3) to reach its conclusion that outside basis is a partnership item. However, the court's decision did not address prefatory language in reg. section 301.6231(a)(3)-1(c)(1) that stated, ''The critical element is that the partnership needs to make a determination with respect to a matter for the purposes stated.'' The court did not explain why the partnership needed to make a determination of the partners' outside bases.

[118] *Tigers Eye*, 138 T.C. at 127-128.

[119] *Id.* at 115.

[120] *Id.* at 154.

[121] *Id.* at 180.

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account by the partnership.[122] The majority also conceded that a ''partner's basis in his partnership interest is an item that is required to be taken into account'' by the partner.[123] If the statute did not include the required account-taking actions of a partner and was limited to those of the partnership, it would be difficult for the Tax Court to maintain that a partner's outside basis is a partnership item. Despite the Tax Court's determination, in its opening appellate brief for *Tigers Eye*, the government conceded that the Tax Court erred regarding its outside basis determination: ''We agree that outside basis is an affected item, not a partnership item, as the Tax Court incorrectly concluded.''[124] Hopefully, the D.C. Circuit will weigh in on this portion of the statute.[125]

4. Comparing *Petaluma* and *Tigers Eye*. It is noteworthy that in *Petaluma* and *Tigers Eye*, the government conceded for purposes of appeal that outside basis was an affected item. It is particularly interesting that the lower courts in both cases held that outside basis is a partnership item. Despite its concession in *Petaluma II*, the government argued that the Tax Court had jurisdiction to determine outside basis in that partnership proceeding because the ''elements are mainly or entirely partnership items.''[126] However, in the *Tigers Eye* appeal, the government does not attempt the same tactic; rather, it concedes that outside basis is an affected item without attempting to include it as a proper subject of the partnership proceeding.

In the context of outside basis, it is helpful to recall the twin objectives of TEFRA: efficiency and uniformity. Given that outside basis is generally unique to a particular partner, it is difficult to discern how it could be the proper subject of a partnership proceeding. The outside basis determination generally has no effect on the partnership or the other partners (except when there is a section 754 election). However, when the partnership is deemed not to exist, as in *Petaluma* and *Tigers Eye*, one could argue that a measure of efficiency and uniformity is achieved through the court's declaration that outside bases are zero. But that conclusion is unnecessary because it is obvious and naturally flows from the court's invalidation of the partnership.[127]

III. Going Forward

As the regulations demonstrate, there are many items that will be partnership items under any set of facts, for example, partnership income and deductions. Those that are susceptible to differing categorizations, such as the items described above, raise several questions about statutory and regulatory interpretation and the breadth of a court's jurisdiction in a partnership proceeding. The scope of the partnership item regulations is quite broad, as demonstrated by the language of the super-partnership item regulation. Also, Treasury has statutory authority to prescribe regulations that say that an ''item is more appropriately determined at the partnership level than at the partner level.''[128]

Although the statutory and regulatory regimes tend to favor the partnership item designation, there are reasons for not treating everything that bears some relation to a partnership as a partnership item. The foremost is the language of the statute itself, which several courts have limited to ''items required to be taken into account for the partnership taxable year'' *by the partnership*. Without that limitation, parties in partnership proceedings could find themselves litigating partner-specific issues, which would be contrary to the purposes of TEFRA.

The IRS also risks being rebuffed by a court for exceeding its statutory authority when it includes partner-specific items in a partnership proceeding. When there is no regulation on point, that risk is heightened. One could argue persuasively that because of Treasury's statutory authority to specify partnership items, courts should resist the government's attempts to amend or supplement the regulations through litigation when it takes positions not specified in its own regulations.[129] However, the

[122]*Id.* at 119 (discussing *Dial USA*, *Meruelo*, and *Gustin*).

[123]*Id.* at 124.

[124]*See Tiger's Eye*, 138 T.C. 67, *sub nom. Logan Trust v. Commissioner*, Dkt. No. 12-1148, Initial Brief for the Appellee, at 32 (D.C. Cir.). Taken out of context, the government's quote could be read as supporting the proposition that outside basis is always an affected item, which is not the case. One clear exception is when the partnership has made a section 754 election and a transfer of a partnership interest has occurred. Reg. section 301.6231(a)(3)-1(a)(3).

[125]Despite the government's concession, the D.C. Circuit is still entitled to review the Tax Court's holding that it has jurisdiction to determine outside basis. *Ruhrgas AG v. Marathon Oil Co.*, 526 U.S. 574, 583 (1999) (''the requirement of subject-matter jurisdiction . . . is non-waivable and delimits federal-court power'').

[126]*Petaluma II*, 591 F.3d at 654.

[127]*Id.* at 655 (''with the invalidity of the partnership conclusively established as a partnership-level determination, there is little danger that outside basis will receive inconsistent treatment at the individual partner level'').

[128]Section 6231(a)(3).

[129]*See, e.g.*, *Exxon Corp. v. United States*, 88 F.3d 968, 974-975 (Fed. Cir. 1996) (the court said that in the absence of a regulation on point despite specific statutory authority granted to the secretary, ''we believe it is not within our judicial powers to legislate in his stead.''); *Woods Investment Co. v. Commissioner*, 85 T.C. 274, 281-282 (1985) (''Since respondent has not taken steps

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IRS seems to be cognizant that it should not push the partnership item classification too far. For example, in the *Tigers Eye* appeal, the government has conceded that outside basis is not a partnership item.

It is incumbent on the courts to act as gatekeepers to ensure that only partnership items are being litigated in partnership proceedings. The IRS has a statutory incentive to include everything it can in a partnership proceeding. If a court determines that one or more of the included items do not meet the definition of a partnership item, the IRS can simply wait for the partnership proceeding to conclude and then issue an affected items notice of deficiency. Hence, the IRS always has a Plan B.[130] Moreover, in the last several years, when TEFRA litigation was prevalent as a result of taxpayers seeking to challenge adjustments to transactions that the IRS determined to have met the listed or reportable transaction definitions, the IRS may have had greater incentive to include as much as possible in the partnership proceeding. Courts generally have disfavored those types of transactions, and if that tone was present in a court proceeding, it certainly did not harm the government's case.

Treating everything as a partnership item has additional risks from a controversy standpoint. A court's holding on one or more issues in a partnership proceeding is binding. Both parties will be subject to those determinations, which will materially affect whether to further litigate in a partner-level proceeding and the scope of that litigation, as well as settlement. There seems to be value in not overburdening a partnership proceeding with non-partnership items so that the court and parties are forced to resolve matters that the parties may abandon on their own.

A. Practitioner Takeaways

Practitioners must evaluate and contest the partnership item characterization when appropriate because of its meaningful implications, for example, the different, and possibly more favorable, venue and applicable circuit law that a partner may be entitled to as determined by the location of his residence versus the venue afforded the partnership.[131] There are also implications in the penalty context. Litigating an item and associated penalties at the partner level allows the partner to raise personal penalty defenses without having to first prepay the penalty. A partner can avoid any unsavory taint of the other partners by litigating an item in a separate partner-level proceeding. Partner-level proceedings also allow a partner to exercise far greater control over the case, for example, discovery, composition of legal arguments, and settlement. A partner who can successfully exclude an item from a partnership proceeding may also benefit from a court's ultimate decision in the partnership proceeding when it comes to deciding whether or how to litigate the non-partnership item(s). Finally, there are instances in which the partnership versus non-partnership item distinction is unclear, and it may be more beneficial to argue that something is a partnership item.[132] Each of those rationales is fact-specific and should be considered in light of an overall strategy.

A practitioner should scrutinize the items included in a revenue agent's report or an FPAA issued to a partnership. One must examine each adjustment and determine how it may affect the partnership as a whole and the other partners. If the item relates to one partner, that is a sign that it may not be a partnership item. At that point, it may be appropriate to raise the jurisdictional argument under section 6226(f). Also, it is always important to remember the twin goals of TEFRA: efficiency and uniformity. Those standards should guide the analysis both during the administrative phase of a tax controversy and before a court.

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to amend his regulations, we believe his apparent reluctance to use his broad power in this area does not justify judicial interference in what is essentially a legislative and administrative matter'').

[130] *See, e.g.*, CC-2009-027 at *14-*15 (advising IRS personnel that they should determine partner identity at the partnership level because, ''even if the court determines the issue must be resolved at the partner level, section 6229(d) will likely suspend the statute of limitations. Duplicative protective nonpartnership procedures may be necessary in some circumstances'').

[131] Under the *Golsen* rule, the Tax Court generally will decide a proceeding in accordance with the law of the circuit to which the case is appealable. A partnership's appeal will lie with the circuit in which its principal place of business is located. Section 7482(b)(1)(E). A partner's appeal will lie with the circuit in which he resides. Section 7482(b)(1)(A).

[132] *See, e.g.*, *Olsen-Smith*, T.C. Memo. 2005-174 (partnership argued that partner identity was a partnership item, because for self-employment tax purposes, it had a favorable effect on the amount and allocation, among the partners, of income reported by the partnership).

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