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From:
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To:
Cc:
Subject:

Pursuant to your request, the following provides a discussion of the legal authorities applicable to your case. If you have any questions, please do not hesitate to contact me or in .

1. Whether a partnership exists is a matter of federal law

Whether a partnership exists for federal tax purposes is a matter of federal, not state, law. Comm'r v. Tower, 327 U.S. 280, 287-288 (1946). An entity's status under local law is not determinative for federal tax purposes. Luna v. Comm'r, 42 T.C. 1067, 1077 (1964). The Internal Revenue Code supersedes local law and prescribes its own standards for determining whether a partnership exists. Id.

Treas. Reg. § 301.7701-1(a)(1) provides that the Internal Revenue Code prescribes the classification of various organizations for federal tax purposes and that, whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

2. Whether a partnership exists for federal tax purposes

I.R.C. 761(a) provides that the term "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation, trust, or estate.

As a threshold matter, an entity separate from its owner must exist before the Service will recognize an arrangement as a partnership for federal tax purposes. Treas. Reg. § 301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent; however, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. See also, Rev. Rul. 75-374, 1975-2 C.B. 261.

Treas. Reg. § 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes that is not properly classified as a trust. Treas. Reg. § 301.7701-2(c) provides that for federal tax purposes, the term partnership means a business entity that is not a corporation under Treas. Reg. § 301.7701-2(b) and that has at least two members. In this case, taxpayers hold a % limited partnership interest as tenants by the entirety. An LLC holds the remaining % interest. Therefore, the entity at issue has at least two members.

A partnership exists for federal tax purposes when one or more persons join together to carry on a trade or business and share in the profits and losses of that trade or business. Tower, 327 U.S. at 286. The primary inquiry is whether, considering all of the facts, the parties in good faith and acting with a business purpose intended to join together in the present conduct of a business enterprise. Comm'r v. Culbertson, 337 U.S. 733, 742 (1949). The following factors, none of which is conclusive, provide evidence of the parties' intent: (1) the agreement of the parties and their conduct in executing its terms; (2) the contributions, if any, which each party has made to the venture; (3) the parties' control over income and capital and the right of each to make withdrawals; (4) whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; (5) whether business was conducted in the joint names of the parties; whether the parties filed federal partnership returns or otherwise represented to respondent or persons with whom they dealt that they were joint venturers; (6) whether separate books of account were maintained for the venture; and (7) whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise. Luna, 42 T.C. at 10771078.

The Commissioner may challenge abusive partnership transactions under various judicial doctrines and statutory rules including sham transaction, economic substance, business purpose, substance over form, step transaction, clear reflection of income, and the partnership anti-abuse rules under Treas. Reg. § 1.701-2.

Exam has not provided specific support for the assertion of any of these theories; however, in the event that they do, we are available to review their proposed arguments. We note that under the substance over form doctrine, a taxpayer is free to organize his affairs as he chooses, but is bound by the tax consequences of his choice. Commissioner v. Nat'l Alfalfa Dehydrating & Milling Co., 417 U.S. 132 (1974). In the present case, taxpayers organized their business as a partnership and must comply with the rules of subchapter K, generally, and in determining each partner's distributive share of income, gain, loss, deduction, or credit. Similarly, Treas. Reg. § 1.701-2(d), Example 1, finds that under general facts , the arrangement satisfies the business purpose, substance over form, and clear reflection of income requirements as those requirements are incorporated into the partnership anti-abuse rules.

3. Allocation of income between husband and wife holding property as tenants by the entirety

I.R.C. § 704(b) provides the rules for determining a partner's distributive share of income, gain, loss, deduction, and credit; however, the sharing of income between husband and wife holding a partnership interest as tenants by the entirety is governed by local law. See Morgan v. Finnegan, 182 F. 2d 649, 650 (8th Cir. 1950); Finney v. Comm'r, T.C. Memo 1976-329 (citing Bour v. Comm'r, 23 T.C. 237, 240 (1954)).

4. Applicability of TEFRA Partnership Rules

As the entity filed Forms 1065 for the relevant tax periods, regardless of whether the entity was a partnership, the TEFRA partnership procedures are applicable UNLESS: the small partnership exception of section 6231(a)(1)(B) is applicable; or, the returns were filed for the sole purpose of making a section 761(a) election. Treas. Reg. § 301.6233-1.

It is our understanding that the entity did NOT file the subject Forms 1065 to make a section 761(a) election.

The small partnership exception is NOT applicable because one of the purported partners identified on the schedules K-1 is a "pass-thru" entity. I.R.C. § 6231(a)(1); Treas. Reg. § 301.6231(a)(1)-1(a)(2). This is true regardless of whether the pass-thru partner is a disregarded entity. See Rev. Rul. 2004-88.

The Service could reasonably determine, based upon the subject partnership returns, that the TEFRA partnership procedures are applicable. See I.R.C. § 6231(g) ("If, on the basis of a partnership return for taxable year, the Secretary reasonably determines that this subchapter applies to such partnership for such year but such determination is erroneous, then the provisions of this subchapter are hereby extended to such partnership (and its items) for such taxable year and to partners of such partnership.")

Note that I.R.C. § 6231(c), and the regulations thereunder (§§ 301.6231(c)-1 through 8), provide for removal of certain partners from application of TEFRA partnership procedures under certain circumstances. Based on the information provided, it does not appear that any of those circumstances are present here; however, we recommend review of that Code section and those regulations. We are happy to provide further assistance if necessary.

Under the TEFRA partnership procedures, prior to assessing the tax liability of the partners, the Internal Revenue Service determines the tax treatment of partnership items in a partnership-level proceeding. I.R.C. §§ 6221 and 6225.

Determinations at the partnership level are binding upon all direct and indirect partners of the partnership. Sente Inv. Club P'ship of Utah v. Comm'r, 95 T.C. 243, 247-250 (1990).

In the absence of a partnership-level proceeding, the Service is bound by the partnership items as reported on the partnership return. Roberts v. Comm'r, 94 T.C. 853, 862 (1990).

The existence of a valid partnership is a partnership item. Tigers Eye Trading, LLC v. Comm'r, 138 T.C. No. 6, 2012 WL 445944 at *16.

The Service should not issue an affected item notice of deficiency before the conclusion of a partnership-level proceeding regarding partnership items that affect the items in the notice of deficiency. GAF v. Comm'r, 114 T.C. 519, 524-528 (2000).