United States Tax Court

Washington, DC 20217

Alexander C. Deitch, et al.,	)	
	)	
Petitioners	)	
	)	
v.	)	Docket No. 21282-17; 21283-17.
	)	
Commissioner of Internal Revenue,	)	
	)	
Respondent	)	
	)	

O R D E R

In these deficiency cases brought pursuant to section 6213, the Commissioner disallowed deductions petitioners claimed on their individual income tax returns for interest expense pursuant to section 163, by issuing on July 14, 2017, statutory notices of deficiency (singularly, a "SNOD") to petitioner Alex Deitch in dkt. No. 21282-17 and to married petitioners Jonathan and Susan Barry in dkt. No. 21283-17. These cases were consolidated and proceeded to trial. The parties have filed post-trial briefs articulating their positions with respect to the disallowance of the interest expense deduction. Neither party has briefed the issue of the applicability of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), but the Court raises that issue *sua sponte* and requests further argument from the parties on the questions raised in this Order.

Alleged interest expense

The deductions for the alleged interest expense at issue are based on an item of expense that West Town Square Investment Group, LLC ("WTS"), which was co-owned by Mr. Deitch and Mr. Barry, reported on its Form 1065, "U.S. Return of Partnership Income", for 2014. The transaction that gave rise to the claimed interest expense was a payment of $1,035,683 that WTS made to Protective Life Insurance Company "PLI" in 2014. (Doc. 10, stip. 58.) This payment constituted 50% of the net proceeds of the sale of a commercial property as calculated pursuant to an "Additional Interest Agreement" into which WTS and PLI had entered when PLI agreed to lend to WTS approximately $4.4 million for the purchase of the commercial property.

WTS issued to Mr. Deitch and to Mr. Barry a Schedule K-1 to Form 1065 showing "net rental real estate income (loss)" of $614,720. (Doc. 10 at 681, 687).

Served 08/25/21

<u>Issuance of SNODs</u>

In each of the SNODs that the Commissioner issued to petitioners, the Form 886-A "Explanation of Adjustments" included the following statement:

> It is determined that your distributive share of the net real estate activity loss from the partnership known as West Town Square investment LLC is ($96,878.00.00) [sic] rather than the ($614,720.00) shown on your tax return. See Exhibit A for details. Accordingly, your taxable income is increased $517,842.00 for the year ended December 31, 2014.

(Doc. 10 at 143, 155.)

<u>Ownership of WTS</u>

The parties have stipulated that "[a]t all relevant times, * * * [Mr. Deitch and Mr. Barry] each owned a one-half interest in West Town Square", establishing that WTS was a partnership with only two partners, both of whom are individuals. (Doc. 10, stip. 13.)

<u>The Commissioner's contentions at trial</u>

The Commissioner asserted for the first time in his pretrial memorandum that

> Substantively, WTS and PLI entered into a joint venture the profits of which they agreed to split. When viewed in this light, the advance from PLI to WTS looks more like a contribution of capital to the joint venture than the loan it is purported to be. In this context, the monthly payments made by WTS to PLI appear more like guaranteed payments as contemplated by I.R.C. § 707(c) than repayments of a loan, and the payment arising from the sale of the shopping center would be considered a distribution of the joint venture's profits.

(Doc. 13 at 6.) Counsel for the Commissioner reiterated this argument at trial, asserting that "the distribution of the proceeds from the sale of the joint venture's key asset cannot be deducted by West Town Square as an interest expense". (Doc. 19 at 21.) In the Commissioner's post-trial briefs, he asks us to find that WTS and PLI "entered into a joint venture to purchase, operate, and eventually sell a shopping center" which joint venture would be taxable as a partnership pursuant to section 761(a). (Doc. 20 at 18.) The Commissioner has explicitly affirmed that "[r]espondent contends that WTS and PLI were joint venturers, not that PLI was a member of WTS". (Doc. 22 at 23.)

Application of TEFRA

The parties agree that the IRS issued to petitioners timely SNODs and that petitioners timely filed their petitions in the Tax Court, which are necessary prerequisites to our jurisdiction under section 6213(a). But our jurisdiction to address issues in a deficiency case is limited to the extent that TEFRA is implicated. Where the IRS would adjust a taxpayer's "partnership items", as defined in section 6231(a)(3), those items "shall be determined at the partnership level", sec. 6221(a), under TEFRA's unified audit and litigation procedures. A "partnership item" is defined by section 6231(a)(3), which states:

> The term "partnership item" means, 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.

Partnership-level proceedings in the IRS may result in the issuance of a notice of final partnership administrative adjustment ("FPAA"), see sec. 6223(a)(2), (d)(2), which may then be the subject of a so-called "TEFRA case" brought in the Tax Court, see sec. 6226(a)(1), (b)(1). These partnership items cannot be litigated in a deficiency case; where no FPAA has been issued, the Tax Court "does not have jurisdiction". Rule 240(c); see also Maxwell v. Commissioner, 87 T.C. 783, 788 (1986).

The SNODs issued to petitioners in this case purport to disallow a partnership item of WTS, an entity that, per the parties' stipulations, falls within the "small partnership" exception of section 6231(a)(1)(B)[1]. But the Commissioner's contentions in this case ask us to characterize an item (i.e., the payment at issue that petitioners contend is interest expense of WTS and that the Commissioner contends is a payment in respect of an equity interest), which he contends is attributable to an alleged joint venture formed between WTS and PLI--a joint venture that, if determined to exist, would for federal tax purposes be a partnership of which WTS is a partner.

If a WTS-PLI joint venture was formed as a partnership for federal tax purposes, the "small partnership" exception could not apply to it, because WTS is itself a partnership, not an individual, or a C corporation, or an estate of a deceased petitioner. See Sec. 6231(a)(9) ("The term 'pass-thru partner' means a partnership"); 26 C.F.R. sec. 301.6231(a)(1)-1(a)(2), Proced. & Admin. Regs. (TEFRA provisions apply if any partner in the partnership is a "pass-thru partner"). Accordingly, if a joint venture was formed by WTS and PLI, it would seem that the WTS-PLI partnership would be subject to TEFRA, and the partnership items of that partnership would likewise be outside our deficiency jurisdiction--i.e., we would lack

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[1]This exception provides in relevant part that "the term 'partnership' shall not include any partnership having 10 or fewer partners each of whom is an individual * * *, a C corporation, or an estate of a deceased partner."

jurisdiction to readjust any partnership items of a TEFRA partnership in the absence of the issuance of an FPAA. Rule 240(c). As we stated in Jimastowlo Oil, LLC v. Commissioner, T.C. Memo. 2013-195, 106 T.C.M. (CCH) 161, 167 (2013):

> The principle * * * that we lack jurisdiction to redetermine affected items attributable to a source partnership before the source partnership-level proceedings have been completed, applies even when the members of the source partnership have failed to recognize that they have created a separate entity (i.e., a partnership) for Federal income tax purposes and have not, therefore, filed a partnership return on its behalf, and the Commissioner has neither conducted a source partnership-level audit nor issued an FPAA to it.

Because the Commissioner's position posits a WTS-PLI joint venture and alleged equity distributions by it, and no party has addressed how the application of TEFRA would impact this case, we will order further briefing from the parties about our jurisdiction to entertain the Commissioner's position. Accordingly, it is

ORDERED that, no later than September 24, 2021, the Commissioner shall file a supplemental brief addressing the following two questions:

1. Does TEFRA deprive us of jurisdiction to entertain the argument that the payment at issue in this case was made in respect of PLI's equity interest in a joint venture formed by WTS and PLI and treated as a partnership for federal tax purposes?

2. If we conclude that we lack jurisdiction to entertain the Commissioner's argument as set forth in the first question above, what issues remain to be decided in the case in light of the parties' stipulations? See Doc. 10, stip paras. 13, 15, 24, 27, 32-35, 68.

It is further

ORDERED that, no later than October 22, 2021, petitioners shall file a supplemental brief responding to the Commissioner's position on the two questions set forth above. It is further

ORDERED that, no later than September 10, 2021, petitioner's counsel shall initiate a telephone conference with respondent's counsel for the purpose of assuring that the possibilities of settling this case have been exhausted.

(Signed) David Gustafson
Judge