1981

Auditing Partnership Tax Shelters: IRS Procedures and Taxpayer Liability

Michael W. Homer
University of Nebraska College of Law, mhomer@sautah.com

Follow this and additional works at: https://digitalcommons.unl.edu/nlr

Recommended Citation
Available at: https://digitalcommons.unl.edu/nlr/vol60/iss3/5

This Article is brought to you for free and open access by the Law, College of at DigitalCommons@University of Nebraska - Lincoln. It has been accepted for inclusion in Nebraska Law Review by an authorized administrator of DigitalCommons@University of Nebraska - Lincoln.
Auditing Partnership Tax Shelters: IRS Procedures and Taxpayer Liability

I. INTRODUCTION

During the past decade tax shelter investments were among the most controversial planning devices used by high-bracket taxpayers. United States Treasury officials have argued that the use of shelters causes an inequitable distribution of the tax burden and introduces "significant distortions into our economy" which "can have the effect of discouraging profitable and efficient enterprise." Some commentators have suggested that certain tax shelters may lead to "widespread, corrosive, scandalous tax avoidance," while others who advocate their use have lauded them as legitimate devices to enable aggressive taxpayers to reduce their tax liability.

1. Tax shelters are used by high-income taxpayers to generate paper losses and thereby reduce taxable income. Losses are obtained by taking advantage of the Internal Revenue Code's treatment of accelerated depreciation, the oil depletion allowance, rental expenses, interest expenses, and intangible drilling expenses. Although there are different investment programs available to generate these losses, the most common types are in real estate, oil and gas, and equipment leasing. For a general discussion of tax shelters, see W. Drolling, Tax Shelters and Tax-Free Income for Everyone 1-18 (1977); 4A R. Haft & P. Fass, Tax Sheltered Investments (Securities Law Series 2d ed. 1974); 2 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners ch. 18 (1980); 2 A. Willis, Partnership Taxation chs. 59-67 (2d ed. 1976).


The Congressional decision to use tax incentives to direct private capital into socially desirable areas of investment, rather than to invest taxpayer funds directly, is a conspicuous one and, despite widespread use of phrases like 'loopholes' and 'tax gimmicks' in the press and by politicians, there is absolutely nothing sinister or illegal about these investments.
To halt widespread investment in "abusive" shelters, the Treasury has asked Congress to enact restrictive legislation; has issued revenue rulings to limit their use; and has begun a sophisticated tax shelter audit program. The most significant substantive limitations imposed on tax shelters were enacted in the 1976 Tax Reform Act and the 1978 Revenue Act which limited the amount of paper losses which investors may deduct and which revised the minimum tax on certain tax preference items. In addition, the Service since 1972 has is-

6. INTERNAL REVENUE SERVICE, OVERVIEW OF TAX SHELTERS 2 (Training 3147-01 1976). The Internal Revenue Service recognizes that there are some shelter investments which are acceptable and has carefully distinguished these from others which are abusive or problem shelters. It considers shelters acceptable when they reflect a congressional intent to stimulate certain social and economic benefits to society. Id. at 1. Problem shelters are those which incorrectly calculate or claim loss items. Abusive shelters are characterized by "[l]oss returns which lack economic reality or viability in varying degrees," which means "any transaction that fails to produce a return relative to the risk involved. . . ." Id. at 2. See also I.R.M. 4236 (351). The Commissioner of the Service has argued that the Service has "no interest whatever in attempting to deny or reduce the tax incentives enacted by Congress. But when some promoters or investment groups seek to go beyond the law, Internal Revenue must act quickly and effectively." Alexander, supra note 3, at 179. However, it is evident that the line between what is fair and what is abusive is often debatable. See, e.g., Administration Views on Tax Shelters, 49 J. Tax. 191 (1978) [hereinafter cited as Administrative Views]:

It is truly interesting to note that what is considered good can be supported by reason of its efficient incentive effect and what is considered bad can be criticized because of its abusive distortive impact on fairness in the tax system, each without regard to any true understanding of the effect of the free market system even in the area of taxes.

Id. (emphasis in original).

7. "Audits" have been referred to as "examinations" by the Internal Revenue Service since July 2, 1978. For purposes of this comment, the term "audit" will be used.


9. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2884. The 1969 Tax Reform Act and the Revenue Act of 1971 also contained provisions designed to limit the spread of tax shelter investments. However, these changes did not anticipate the widespread use of the syndicated partnerships by investors to take advantage of a variety of tax incentives. See note 16 infra. The impact of the 1969 and 1971 Acts on tax shelter investments is outlined in Alexander, supra note 3, at 174. See also W. DROLLINGER, supra note 1, at 7-8.

10. Law review articles concerning the effect of the 1976 Tax Reform Act on tax shelters are legion. Among the best are: Sexton & Charyk, Partnerships as Vehicles for Tax Shelter Arrangements Curtailed by TRA, 45 J. Tax. 338 (1976); Leifer, 1976 Tax Reform Act Effect on Partnership Tax Shelters, 35 N.Y.U. INST. FED. TAX. (pt. 2) 51 (1977); Comment, New Restrictions on Tax Shelter Limited Partnerships, 56 Neb. L. Rev. 300 (1977); Weiler, The 'At Risk' Rules: A New Consideration for Tax Shelter Investments and Partnerships,
sued rulings making it more difficult to organize a shelter around a
limited partnership.11

The Service’s other major device to limit tax shelter abuse has
been its tax shelter audit program which is the major focus of this
comment.12 Through this program the Service has channeled its
efforts to locate abusive tax shelter schemes and to treat partner/
investors uniformly in accordance with national standards. This
comment will examine the organization of the program and the
procedures followed to insure uniform and fair tax treatment.13

Consideration also will be given to administration proposals to
overhaul taxation of partnership tax shelters and to the congres-
sional response to these proposals.14 Finally, current proposals to
streamline the auditing procedures of tax shelter partnerships and
the appeals process following the assessment of tax liability will be
examined.15

II. IRS TAX SHELTER PROGRAM

A. Background

During the 1970s, limited partnerships began to be widely used
as vehicles for syndicating large tax shelters.16 Almost immedi-
ately the Service became concerned that the participants were

11. See § II of text infra.
12. See § III-B of text infra.
13. See § III-C of text infra.
14. The limited partnership is an ideal tax shelter vehicle because it enables
investors to pool their capital in a common enterprise generating front-end de-
ductions, which are passed through to the partners for inclusion on their
individual tax returns. See 2 A. WILLIS, supra note 1, at 161-62. Although
sheltering income may be achieved through other means (e.g., individual in-
vestments in real estate, investments through a subchapter S corporation)
large scale investments involving thousands of taxpayers in one investment
are best conducted in partnership form. These types of syndicated tax shel-
ter investments began to proliferate in the 1970s. Id. at 161.
abusing the tax laws and, in addition to proposing substantive changes in the Internal Revenue Code, initiated a stepped-up audit program to identify and curtail such abuse.17

In a speech before the Cleveland Tax Institute on November 15, 1973, the Commissioner of the Internal Revenue Service, Donald C. Alexander, outlined the Service's audit program of tax sheltered investments. He indicated that the investments would be examined to determine whether 1) the investors could "reasonably expect to earn a profit appropriate to the investment and the degree of risk involved;" 2) the business was actually involved in the transaction claimed; and 3) the investors were actually making property loss claims from the investment.18

The commissioner indicated the audit process would begin at the partnership level rather than with the investor "because of the number of entities and individuals involved." Uniform treatment of taxpayers would be achieved through the establishment of a "nationwide examination program coordinated by the National Office."19 However, the Service was unsuccessful in achieving this uniformity during the first several years of the program's operation, perhaps because of the rapid increase in partnership formations, both in type and numbers, which caught the Service unprepared.20 This became evident in January 1975 when an IRS official noted that auditors of the Service had "neglected partnership returns because partnerships are not tax-paying entities."21 Evidently, the auditors had assumed that any tax problems "would show up when individual partners' returns were audited," but they were "'shocked' by what they missed by concentrating on individ-

17. See Alexander, supra note 3, at 177-78.
18. Id. at 177. The Commissioner seemed most concerned about oil and gas shelters in his address.
19. Id. at 177-78.
21. Wall St. J., Jan. 22, 1975, at 1, col. 5. A partnership is required to file only an information return. I.R.C. § 6031. The return is filed on form 1065. But the partnership is not a taxpaying entity; instead, the Internal Revenue Code taxes the partners as individuals rather than the partnership itself as a separate entity. Thus, the partners pay taxes on partnership income, while the partnership acts as a conduit. The partnership is required to provide each partner with an accounting of his share of the partnership's income, loss, deductions, and credits on form K-1. The partner transfers this information to his individual return. An additional copy of schedule K-1 is attached to the partnership form 1065 along with schedule K, which is a summary schedule of all the partners' shares of the income, deductions, and credits of the partnership. See SPADA & RUGE, PARTNERSHIPS—STATUTORY OUTLINE AND DEFINITION 1 (BNA Tax Management Portfolio 161-2d 1978).
To overcome these problems, the Service in 1977 promulgated procedures which adopted an "entity" approach to auditing partnership activities. By the Service's own admission, part of the difficulty in adopting the "entity" approach lay in the peculiar nature of the partnership itself. Partnerships are treated by the tax laws as both "an aggregation of individuals, each of whom should be treated as the owner of a direct undivided interest in partnership assets and operations" and as "a separate entity, apart from the partners." The first is the "aggregate" concept, and the second is the "entity" concept of partnerships.

The Internal Revenue Code uses both concepts in determining the tax liability of partnerships. For example, "[t]he aggregate concept predominates in connection with the taxation of partnership income to partners," whereas the entity approach "predominates in the treatment of transfers of partnership interests . . . ." However, even within these areas the concepts blend. As a leading treatise noted, "this blending of aggregate and entity concepts is one of the primary sources of uncertainty in the interpretation and application of Subchapter Y." Although under the aggregate concept partnership income is taxed to the partner and not the partnership, the widespread use of large syndicated partnerships made it essential that returns be examined carefully at both the partner and the partnership levels. Thus the program adopted by the Service provided that the district which audited a partnership information return would also insure

In the past year, in response to the changes in the nature of partnerships and because of tax abuses present in these syndicated partnerships, we have substantially changed our audit procedures and increased our audit coverage. In the past the majority of our partnership audits were the result of issues first identified on an individual return, traced back to the partnership, and then identified on the returns of other partners. This back door approach to partnerships was not a particularly effective way of determining those partnership returns most in need of audit. *Hearings, supra* note 20, at 5830. (statement of Jerome Kurtz). For a discussion see § II-B, infra.
24. 1 W. McKee, W. Nelson & R. Whitmire, *supra* note 1, ¶ 1.02[1].
25. Id. ¶ 1.02.
26. Id. ¶ 1.03.
27. Section 701 of the Internal Revenue Code reads: "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." I.R.C. § 701. *See also* 1 A. Willis, *supra* note 1, § 2.02.
that the returns of all partners would be audited as well. This entity approach was necessary to insure that the investors in a partnership would be treated under uniform standards, and to improve communications between the various districts in which the investors resided.28

B. Organization

Prior to the publication of the present format of the Internal Revenue Service tax shelter audit program in December 1977,29 audits of partnership shelters were not incorporated into the Service's regular audit program.30 But it had become essential to coordinate the tax shelter program with the regular auditing procedures because of the increasing volume of returns which revealed potential tax shelter abuses despite the severe limitations placed upon such shelters by the 1976 Tax Reform Act. This was possible because by 1977 the Service had experience in examining shelter cases and identifying tax shelter issues and had developed positions relative to the prevalent tax shelter abuses.31

Under the present tax shelter program, additional responsibilities are delegated to existing personnel at the national and field offices.32 At the national office, the Director of the Audit Division has responsibility “for the overall planning, coordination, monitoring and evaluation” of the program, as well as for “assuring that the program coverage is uniform.”33 To fulfill these responsibilities, the Director must develop guidelines and procedures, establish liaison with other national office functions, provide assistance

28. 1977 I.R.M. Supp., supra note 23, at § 1.02. Although this manual supplement has since been withdrawn, the purpose section, which was not incorporated into the manual, indicated why the Service initiated the program. In 1978 the Carter Administration sought to further erode the aggregate concept of partnership taxation by proposing an entity approach, which would allow the initial determination and subsequent adjustment of taxes at the partnership level. See § III-A infra.


31. Id. For a discussion of the Service's position on selection of cases, see § II-C infra.

32. I.R.M. 42(17)7 (Dec. 9, 1980). For a brief summary of the various responsibilities of personnel in the Service's national and field offices, see A. Santa Barbara, supra note 12, at 5-41.

33. I.R.M. 42(17)2.1 (Dec. 9, 1980).
to establish an effective training program, and submit information gathered by the districts concerning "new or unusual schemes" to the assistant commissioner in charge of technical divisions, who in turn will use the information to establish the Service's position for dissemination to the public. Thus the national office has the primary responsibility for the overall operation of the program and for establishing procedures and substantive positions.

Also, the assistant regional commissioner in charge of audits is to designate an analyst responsible for the operation of the tax shelter program at the regional level and for coordinating the program with the national office, other regional and district offices, and service centers. As the principal field office, the regional office is generally responsible for putting service policies into effect. The analyst has the responsibility to educate, "as appropriate, regional, district, and service center personnel on their tax shelter responsibilities" and to insure that the districts are implementing the program by auditing both promoters and investors. He also screens information which the district submits to the national office for technical advice and submits other "information on new or unusual tax shelter schemes or issues . . . that would be useful to examiners . . . ." In effect, the regional analyst is responsible for transmitting the shelter program supplied by the national office to the districts and service centers and for insuring that they uniformly and consistently implement its provisions.

The district office, as the field office which conducts the audits and is closest to the taxpaying investors and promoters, is the most important link in the tax shelter program. If the district offices fail to operate the program in a uniform and consistent manner, the goals of the program will fail. Each district director is required to communicate with state securities agencies in order to anticipate novel tax shelter schemes. The chief of the Audit Division must submit to the assistant regional commissioner a plan for dealing with tax shelters and must assign a coordinator to synchronize the district shelter program with the region and other districts. The coordinating districts (those which have jurisdiction over the partnership) are required to "establish and maintain communication with other districts and regions, as appropriate, to expedite the examination of the tax shelter return" and must keep the regional field office informed about novel shelter techniques.

34. Id. See § II-C infra for a discussion of the positions taken by the Service.
35. I.R.M. 42(17)2.2 (Dec. 9, 1980).
36. Id.
37. Id.
38. I.R.M. 42(17)2.3 (Dec. 9, 1980).
39. Id.
The tax shelter program also delegates responsibilities to the audit group or case managers (those who have the responsibility of selecting returns for audit), including: 1) insuring that audits are conducted expeditiously and consistently by assigning them to examiners who can complete them quickly; 2) providing guidance to examiners; and 3) closely coordinating, controlling and monitoring shelter audits with district program coordinators.40

Illustration 1—Tax Shelter Program Organization

Thus the tax shelter program plugs into the elaborate network of offices within the organizational hierarchy of the Service and makes them responsible for tax shelter examinations. Through proper coordination and communication, this network will operate to identify and ultimately eliminate abusive shelter schemes. The next two subsections will review how this organizational structure

40. Id. Because large syndicated tax shelters often include partners from many different tax districts, it is essential that other districts auditing partners' individual returns be notified by the district conducting the partnership audit. See § II-C infra.
operates to prevent tax shelter abuses and will examine the types of shelters which receive the strictest scrutiny.

C. Procedures

The Internal Revenue Manual Supplement issued in 1977—which outlined the tax shelter program—not only established an organizational framework but also set out the procedures for the audit itself. Later manual supplements have included additional audit procedures. From these sources it is possible to trace the procedures through which partnership returns travel in the tax shelter audit program.

Partnership returns are first processed at a service center where they are categorized into four general areas: 1) net loss of $25,000 or more; 2) net loss of $1 to $25,000; 3) net profit of $0 to $25,000; 4) net profit of $25,000 or more. The returns are then sent to the district field office which determines if audits are warranted.

Some returns, classified as “potential tax shelter” returns are “automatically delivered to the Examination Branch” from the service centers. Although the current procedures and criteria used to determine which returns are to go directly to the District Examination Division before prior screening are no longer open to the public, the Service probably considers factors similar to those released in March 1979. That supplement to the Internal Revenue Manual required that a partnership return be classified


42. I.R.M. 4142 (Oct. 17, 1980). See also Hearings, supra note 20, at 5831; Kurtz, supra note 30, at 775.


44. The Service has removed the material relating to the “[p]rocedures and criteria for the identification and selection of returns to be included in the Tax Shelter Program” from the Internal Revenue Manual and placed it in its Law Enforcement Manual. I.R.M. 4141(5) (Oct. 17, 1980). Although the former material may be obtained by the public through the Freedom of Information Act, items in the Law Enforcement Manual are not open to public inspection.

45. On March 21, 1979, the Service released I.R.M. Supp. 41G-130, which contained information to aid in the identification and selection of 1978 partnership returns for the tax shelter audit program. When this supplement was later incorporated into the manual “without change,” the selection criteria were classified. Thus, although the criteria listed in the 1979 supplement are probably still used, at least to some extent, it is likely that they have been
as a potential tax shelter return and delivered to the Examination Branch for additional screening if it met all the requirements in any one of the following six classifications:

"A"—1. Return is the first one filed, and
   2. Average Loss per partner is $10,000 or more, and
   3. Partners capital account—BOY (beginning of year) and Partners capital account—EOY (end of Year) are both zero, or partners capital account—EOY is negative.

"B"—1. Either BOY or EOY partner's capital account is negative by an average of $10,000 or more, and
   2. This is the final return.

"C"—1. Net LTCG (long-term capital gain) / loss (LTCL), net LTCG/LTCL under Section 1231 or specialty allocated LTCG/LTCL averages $10,000 or more per partner, and
   2. Reported gain is zero or negative.

"D"—1. A decrease in EOY over BOY balances of $10,000 or more in a capital asset or capital asset related (e.g. accum. depletion, accum. amortization) account, and
   2. No net long-term gain or loss, no net Section 1231 net gain or loss and no ordinary gain or loss is reported.

"E"—EOY balance for any of the following items has decreased from the BOY balance by an average of $10,000 or more per partner;
   1. mortgages payable—current
   2. mortgages payable—long term, or
   3. non-recourse loans.

"F"—1. Non-recourse loans (BOY or EOY) average $10,000 or more per partner, and
   2. A loss or a profit of $5,000 or less is shown.46

However, the mere fact that a partnership return is forwarded to the Examination Branch because it satisfies one of the above tests does not mean the return will be automatically audited. But it will receive intense scrutiny by the examiners.

Once a partnership return arrives at the district field office, a determination must be made whether to forward it to the district tax shelter coordinator “for consideration for inclusion in the tax shelter program.”47 Presumably, this decision can be made by an examiner or the return program manager. The manual lists essentially the same items as those issued in 1977 for consideration at this stage.48 They include:

---

47. I.R.M. 42(17)3 (Dec. 9, 1980).
48. When the Service first issued criteria for determining potentially abusive tax shelter returns, some commentators assumed that these were replacing those originally included in the 1977 Tax Shelter Program Supplement, see, e.g., 2 A. WILLIS, supra note 1, at 28 (Supp. 1980), whereas others assumed they were simply additional criteria to be considered. See New I.R.S. Guidelines, supra note 41, at 378. “Presumably, the previous items that Service
(a) large net loss,
(b) low gross income,
(c) large amounts of investment credit,
(d) first year return,
(e) final return,
(f) section 761(a) election,
(g) nonoperating entity,
(h) a passive investor,
(i) nonrecourse or not-at-risk question(s) not answered or answered affirmatively (other than real estate),
(j) activity engaged in an identified tax shelter area,
(k) negative capital account if a partnership (not real estate), and
(l) ... additional factors that should be considered.49

If it is determined that the return should be forwarded to the district program coordinator, then the coordinator, using the information supplied,50 must determine whether the shelter should be included in the tax shelter program. While he is making this determination, the audit of the return continues.51

The coordinator must inform the group manager whether the case will be included in the tax shelter program.52 If he decides to exclude the return from the program, the coordinator must give the examiner reasons and instruct him to complete the audit and close the case.53 If it is included, the coordinator must also inform the examiner and send a copy of the referral to the regional analyst, who will forward it to the national office.54 Other procedures are required of the coordinator if a multi-tier partnership is involved.55 Either a partnership return (form 1065) or an individual return (Form 1040) may be submitted for inclusion in the tax shelter program.56 If it is an individual return the coordinator may not

personnel in the Tax Shelter program were on the lookout for in determining a tax shelter partnership will still be taken into account." Id.

49. I.R.M. 42(17)3 (Dec. 9, 1980).
50. The following information will be submitted through the group manager to the district program coordinator: "A copy of page one and pertinent schedules and pages from the tax return, along with the examiner's name, group number, telephone number, and other helpful information." I.R.M. 42(17)3 (Dec. 9, 1980). These are essentially the same requirements contained in the 1977 Supplement, which included:
   1. taxpayer's name, address, identification number, taxable years under examination;
   2. number and type of related returns;
   3. taxpayer's principal business;
   4. basic criteria identified and reason for referral; and
   5. examiner's name, group number, and telephone number.

51. I.R.M. 42(17)3 (Dec. 9, 1980).
52. Id.
53. Id.
54. Id.
55. Id.
56. See note 28 & accompanying text supra.
include it in the tax shelter program, but instead must forward the information to the coordinator in the district having jurisdiction over the partnership. The coordinating district will then determine "whether or not to include the case in the tax shelter program and will notify the requesting district of the decision."\(^{57}\)

As already noted, one main purpose of the program is to insure uniformity and achieve coordination. If it is determined that a partnership return should be included in the tax shelter program, the process of coordinating the partnership audit with the districts in which each partner has filed his individual tax return will begin.

The coordinating district informs each partner's district that the partnership is being included in the program by sending Form 918-A to the districts.\(^{58}\) These districts can continue to audit all items of the individual partners' returns except partnership income: "Unless the interest of the government would be jeopardized by delay, the District Director will not complete action on the individual returns until he receives either a Notice of Agreement as to the adjustments, or a copy of the report of the adjustments of the entity's income."\(^{59}\) During the audit of the partnership, the partner's district can request information concerning the status of the partnership audit and ask that it receive the final partnership examination results, including the adjusted partnership distributions.\(^{60}\) The coordinating district must also submit a report to the assistant regional commissioner in charge of audits concerning each partnership audit included in the program.\(^{61}\)

From a partner's perspective, the procedures followed in the tax shelter audit program make it important that caution be exercised when entering into a partnership agreement. Any suspicion by the Service that any partner is attempting to evade the tax laws, either in the partnership information return or the individual return (whether on partnership items or not), could result in a complete audit of each partner's return, including nonpartnership items. When entering into a partnership, a taxpayer should know as much as possible about the other taxpayers with whom he will be associated. While under current law partners have the right to have the Service's determination of partnership items reviewed, and, in the event such a review is unsatisfactory, they can appeal the decision of the Service, current proposals for changes in the

\(^{57}\) I.R.M. 42(17)3 (Dec. 9, 1980).
\(^{59}\) Hackett, supra note 30, at 856. For a discussion of the adjustment process, see § III infra.
\(^{60}\) I.R.M. 42(17)6 (Dec. 9, 1980).
tax law could, in the future, deny an individual taxpayer this opportunity.62 Because investors will want to avoid being audited each year, they should be aware of any Service position that their tax shelter investment is abusive and should avoid association with other taxpayers who are particularly susceptible to audits because of other nonpartnership activities.

Illustration 2—Tax Shelter Program Procedures

62. For a discussion of some of these proposals, see § III-C infra.
D. Types of Shelters Examined

The first tax shelters to arouse the concern of the Service were oil and gas syndicated limited partnerships. These types of investments caused Commissioner Alexander to organize the first national auditing program of tax shelters in 1973.63 This program included the exchange of information between the Service and the Securities and Exchange Commission to identify and "prevent fraud, sham transactions and tax abuses."64 When promoters of large syndicated partnerships developed other types of investments to shield income from taxes, the Service responded by expanding its program to include other types of shelters (e.g., real estate, farming, and motion pictures shelters).65

As already indicated, the directors of the Examination Divisions are required under the tax shelter program to submit "[i]nformation from districts concerning new or unusual tax shelter schemes" to the assistant commissioner for technical divisions.66 This information is used to formulate the government's positions which may be issued as revenue rulings.67 In addition, district coordinators are encouraged to seek technical advice on issues confronting them.68 The Service also publishes other information to aid auditors in the examination of tax shelter investments.69

One of the most widely used publications is the Examination Tax Shelters Handbook. The types of shelters currently included in this publication include motion pictures investments, real estate, farm operations, oil, gas, coal, and equipment leasing.70 Al-

63. See note 3 & accompanying text supra.
64. Kurtz, supra note 30, at 774.
65. Id. Hackett, supra note 30, at 832-33.
68. I.R.M. 42(17)7 (Dec. 9, 1980).
69. See, e.g., INTERNAL REVENUE SERVICE, OVERVIEW OF TAX SHELTERS (Training 3147-01, 1976); INTERNAL REVENUE SERVICE, EXAMINATION OF TAX SHELTERS (Training 3178-02, 1978); INTERNAL REVENUE SERVICE, TAX SHELTER GUIDELINES (1978); INTERNAL REVENUE SERVICE, EXAMINATION TAX SHELTERS HANDBOOK (I.R.M. 4236, 1979) [hereinafter cited as HANDBOOK].
70. HANDBOOK, supra note 69.
though a review of the government’s positions relative to each type of shelter contained in this handbook is not possible here, it should be noted that the purpose of the handbook is to provide a basis for uniform decision-making by district examiners and to be used as an instructional tool to expedite the examination process.

E. Illustration

Assume that P is a limited partner in X partnership. P resides in Cheyenne, Wyoming, and the partnership is conducted in Omaha, Nebraska. The partnership consists of several thousand investors who are limited partners and a group of promoters who are the general partners. The partnership takes the invested funds and uses them to construct high-rise luxury condominiums, shopping centers, and office buildings. The limited partners have invested money into the partnership to take advantage of tax losses promised in the prospectus, specifically interest deductions and accelerated depreciation. Other investment partnerships organized by the same promoters have never made a profit and partner P is not as concerned with realizing a profit as he is with generating deductions for his already high-bracket income. The prospectus made no profit projections for the investments.

During its first year of operations, the partnership sustains a large loss. P’s share of the losses amounts to over $30,000. The average loss per partner is about $15,000, and many of the partners have generated losses equal to their investment in the first year. P files his 1040, with an attached copy of form K-1, and mails it to the Service’s Ogden, Utah service center. X Partnership files the 1065 information return, with copies of form K and a copy of each partner’s form K-1 attached, and mails it to the Ogden service center.

Upon its arrival at the Ogden service center, the partnership return will be categorized as one with a net loss of greater than $25,000 before being sent to the Omaha, Nebraska district office. In this case, because the partnership return is the first one filed, the average loss per partner is $10,000 or more, and most partners now have negative capital accounts, the return will also be automatically forwarded to the examination branch. While this does not mean that it automatically will be audited or become part of the tax shelter program, under these facts, it is very likely that the return would be audited and the district coordinator would be consulted in order to include it in the tax shelter program.

If the district coordinator decides to include the return in the program, he will inform the group manager that it has been selected and will send a copy of the referral to the regional office. He will also send form 918-A to the district of partner P (Cheyenne District) as well as to the districts of all other partners so that
these offices will hold the partnership portion of these partner's individual returns in suspense until the completion of the partnership audit.

Prior to the arrival of form 918-A, the Cheyenne district office could independently decide to inform the Omaha district office that the partnership activities from which partner P was claiming losses may be an abusive shelter and should be audited under the program. If so, the Omaha district office would use information from Cheyenne to decide whether to include the partnership in the program.

Once the audit begins, the examiners consult revenue rulings and other Service publications to ascertain the Service's position on the type of shelter involved and whether some of the partnership losses should be denied and the return amended because tax laws have been abused. Chapter 300 of *Internal Revenue Manual* 4236 contains information about real estate tax shelters, which would be consulted in evaluating the partnership return in this illustration. If it is determined that the partnership was set up primarily for tax avoidance, many of the losses claimed by the partnership might be denied. If the Service has not yet taken a position on some of the features of the shelter, the district coordinator would submit information to the assistant regional commissioner and the national office for technical assistance.

When it is determined that a partnership's income or loss should be adjusted, it is necessary to reflect the adjustment in the income or loss of each partner in the partnership. This process at present must be done on a partner-by-partner basis, unless a partner waives his rights to individual consideration. Furthermore, the law provides opportunities for challenging the Service's adjustments—both administratively and in the courts. This process of adjustment poses problems which, along with some proposals for improvement, will be the subject of the next section.

**III. ADJUSTMENTS AND PARTNER'S LIABILITY**

**A. Background**

As noted in the previous section, the Service's tax shelter program is based on the entity concept of partnerships.71 Before it began to concentrate its auditing efforts on partnership information returns, the Service found that it was failing to identify a substantial number of abusive tax shelter schemes.72 Now there is a coordinated effort to identify these schemes at the partnership

---

71. See note 28 & accompanying text *supra*.
72. See notes 21-28 & accompanying text *supra*. 
level. Once these schemes have been identified, a coordinated audit is made of both the partnership and its partners. But even though the Internal Revenue Service may examine a partnership information return, it cannot, under present law, make adjustments to partnership taxable income at the partnership level which are binding at the partner level. Because partners are responsible to pay taxes on income from partnership activities, the adjustments made to partnership items, to be effective, must be reflected in the partners' returns.

To accomplish this, "the Service must audit each partner separately with respect to partnership matters, even though each such audit may involve the same substantive partnership determinations." Thus, in actual practice the propriety of partnership computations and allocations must be determined at the partner level for purposes of tax liability. Even "[a] settlement arrived at by one partner with an agent is not binding on any other partner or on the agent who deals with such partners. Similarly, a judicial determination of a partnership tax dispute may be conclusive only as to those partners who are parties to the proceeding." The result is that "[p]artners are free to challenge partnership level determinations and, in effect, reopen the partnership audit in their local districts."

The Treasury has argued that this "aggregate concept" of adjustments and imposition of tax liability imposes a difficult administrative burden on the government. It has pointed out that:

Once a partnership issue is raised, the Service must locate and review the partnership return while placing the partner's return in "suspense" pending completion of the partnership audit.

... If an examination is required, the partner who signed the return will be contacted and arrangements made to conduct the examination. At the same time, the Service must identify, locate, notify and obtain waivers of the individual statute of limitations from each partner. This may be an extremely difficult process.


74. PREPARED STATEMENTS, supra note 2, at 169.

75. Id.

76. Id. at 171.

77. Id. at 170. The Service tries to have as many partners as possible waive their individual statute of limitations "while a limited number of 'test' cases proceed through litigation. This 'suspending' of partner returns keeps the returns open for all issues, until the partnership issues are settled." Id. at 171. Commissioner Kurtz, in his testimony before the House Ways and Means Committee, noted that:

While the agent controlling the partners' individual return awaits the findings of the partnership examination, he generally examines the other issues on the partner's return and attempts to resolve those
This difficulty springs from the characteristics of the syndicated partnership: the taxpayer/partners are widely dispersed geographically; partnerships are often partners in other partnerships; and partnership returns contain incomplete, inaccurate, or out-of-date information.

Additionally, before the 1978 Revenue Act, the relevant statute of limitations began to run even while the Service was attempting to locate all the partners of a tax shelter. In some situations, the limitation period had run by the time a particular partner could be located. Even those partners who were found could refuse to waive the limitation period, "forcing the Service to issue a deficiency notice for some partners and not others." Such a notice would force a partner into court before the Service had fully evaluated all the problems associated with the partnership return and could invite other partners to join the suit, causing multiple litigation of the same issue.

Although the statute of limitations problem was partially resolved by the 1978 Revenue Act, the problems of multiple litigation and overlap remain. The two requirements the government had hoped to change in order to avoid this duplicity were: (1) "the Service must separately control each tax return which includes an item attributable to that partnership," in order to audit a partnership; and (2) "even if the Service successfully initiates and manages a partnership audit, each partner may separately determine where and when his partnership matter will be determined." Although the Service was successful in limiting the administrative burden of complying with these requirements, it failed to convince Congress to adopt an entity approach in determining a partner's liability and in adjusting partnership returns.

---

issues with the partner and obtain the partner's consent to any necessary extensions to the statute of limitations to permit conclusion of the partnership audit.

Hearings, supra note 20, at 5831 (statement of Jerome Kurtz).

78. I.R.C. 6501(a).

79. PREPARED STATEMENTS, supra note 2, at 170.

80. Where the taxpayer is unwilling to execute further consents to extend the period of assessment, a statutory notice of deficiency must be issued to the taxpayer who must then file a petition in the Tax Court or pay the asserted deficiency and sue for a refund. In such a situation, the Service faces the possibility of multiple litigation, perhaps in different courts, involving the identical partnership issues.

Hearings, supra note 20, at 5832 (statement of Jerome Kurtz).

81. PREPARED STATEMENTS, supra note 2, at 171.
B. 1978 Revenue Act and Partnership Audits

1. Administration Proposals

In order to minimize the difficulties inherent in auditing a partnership return (summarized in the previous subsection), President Carter proposed a sweeping change in partnership tax law. The changes were an attempt to adopt the entity concept for determining taxpayer liability resulting from partnership tax shelter activities. The original proposal would have established “procedural rules allowing the Internal Revenue Service to make an audit determination at the partnership level which ultimately, would be binding on the partners if it is either agreed to by a representative of the partnership or sustained in court in litigation between the Service and the partnership.”

Each partner would be notified “both as to the commencement of the audit of the partnership return and the result of the audit.” The President also proposed taxing partnerships with fifteen or more limited partners as corporations. Neither proposal passed Congress. With regard to the proposal to make adjustments to partnership income and losses at the partnership level, it was successfully argued by witnesses at congressional hearings that the adoption of such an entity approach would “discourage the normal tax audit settlement procedures,” would result in increased expense to the partnership, and would create “difficulties in translating the partnership-

82. SUMMARY, supra note 73, at 20-21.
83. Id. at 21.
84. Hearings, supra note 20, at 4438 (statement of Wallace R. Woodbury). See also id. at 4613 (statement of Miles H. Tanenbaum):
Presently, if an individual partner is disputing both an issue relating to his distributive share of a partnership item and an issue unrelated to the partnership, a compromise on both issues may be reached between that taxpayer and the Service. Under the proposal, however, since the settlement must be at the partnership level and is binding on all partners, this type of compromise could not be reached if even one partner objected.
85. Id. at 4613. “[S]ince the disagreement of one partner can prevent a settlement, the partnership will incur expenses which may only be attributable to one partner.” Id.
86. Id. at 2392 (statement of Robert R. Statham). The proposal “would severely impair the rights of individual taxpayers to determine their own tax liability.” Id. at 2392 (statement of the American Petroleum Institute, Mid-Continent Oil and Gas Association, Rocky Mountain Oil and Gas Association, and the Western Oil and Gas Association). In addition, it was argued that the power to be given by the proposal to the general partner to waive the partnership’s statute of limitations, “thereby keeping each partner’s return open for changes attributable to the partnership,” would greatly prejudice the participation by the partners because “any general partner would be ‘presumed authorized’ to bind the partnership, despite any objection of the remaining
level determinations into taxpayer assessments."87 These arguments prevailed, despite other arguments that the proposal would result in such advantages as simplification and reduction in the administrative cost of the audit procedures, "greater certainty with respect to the tax consequences for individual partners," greater "equality of treatment among similarly situated taxpayers," and a more sensible and sensitive means of discovering and correcting abuses.88 With regard to the proposal to tax partnerships as corporations, it was successfully argued that this would constitute a "meat ax approach" to the problem of tax shelters.89

However, Congress did enact several measures designed to provide the Service with adequate information to conduct its partnership audit program and to extend the time in which it may conduct these audits. Although they fell short of the President's proposal to make the partnership an "entity" for auditing purposes, they did give the Service additional leverage for attacking tax shelter schemes. The remainder of this subsection will discuss the two changes enacted in 1978 which affect the auditing of partnerships. The next subsection will discuss other proposals currently under consideration to centralize the auditing and adjustment process.

87. Simplification, supra note 86, at 52 (statement of Fred W. Peel). The difficulties noted by Peel included: "When would interest begin to run, and on what? Would collection procedures be stayed until the partnership-level determinations were converted into assessed taxes?" Id.
88. Hearings, supra note 20, at 4476 (statement of William J. Langelier).
89. Id. at 5703 (statement of Frank V. Battle, Jr.). "The Administration proposal would penalize partners actively engaged in business rather than dealing only with situations where a passive limited partnership may be set up to generate artificial tax losses .... [T]he provision discriminates against the smaller investor who can only afford to invest as part of a larger group." Id. at 1504-05 (statement of the Securities Industry Association). "[T]he proposal could result in many joint operations in the petroleum industry being taxed as corporations even though these organizations are not formed for tax shelter purposes." Id. at 3095 (statement of Shell Oil Co.). "The Treasury's supposition that limited partnerships above a certain size are equivalent to corporations is, as a general proposition, incorrect .... [S]uch an arbitrary rule makes a mockery of the balancing of corporate and noncorporate attributes mandated by the Supreme Court in the Morrissey case ...." Id. at 5703-04 (statement of Frank V. Battle, Jr.).
2. Penalty for Failure to File Partnership Return

One of the problems with the pre-1978 aggregate auditing approach was that a taxpayer-partner's statute of limitations began running from the date his individual return was filed, even if the partnership filed an incomplete information return or failed to file one at all. This created an opportunity for partnerships to either withhold information from or delay filing its returns when the partners were attempting to avoid audit. Since the emphasis of the Service's tax shelter program is on identifying abusive tax shelters from partnership information returns, many participants in tax shelters could avoid identification when partnership returns were not timely filed. If returns were filed with only a partial listing of partners, some could avoid the consequences of auditing adjustments by the expiration of their statute of limitations before they could be located.

Prior to the 1978 Act, the only provision in the Code for the failure to file a partnership information return was a criminal penalty for the willful failure to file the return, supply information, or pay the tax.\(^90\) Under new Code section 6698, the partnership is now liable not only for a "willful" failure to file a complete partnership return but also for failure to file a complete return, "unless it is shown that such failure is due to reasonable cause."\(^91\) Thus a partnership may now be penalized for failure to file a timely and complete return, even though such failure may not have been willful.

In order to avoid being penalized under the new provision, the partnership must file a timely information return which contains all of the information required by the Code, i.e., "the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual."\(^92\) Compliance with this requirement will increase the efficiency of the tax shelter program because the Service will have adequate information to conduct an audit, inform all of the partners that such an audit is taking place, and seek a waiver of the partners' statute of limitations, when needed.

The penalty imposed under section 6698 to insure compliance with filing requirements is based upon the number of partners in the partnership and the time elapsed since the partnership return was due, rather than upon the amount of unreported income. This makes the penalty especially heavy for large syndicated partnerships. The monthly amount of the penalty is "$50 multiplied by the number of persons who were partners in the partnership during

\(^{90}\) I.R.C. § 7203.
\(^{91}\) I.R.C. § 6698(a)(2).
\(^{92}\) I.R.C. § 6031. This includes the attachment of a completed balance sheet.
any part of the taxable year." The penalty continues for as long as the failure to file a complete return continues, up to and including five months.

While the penalty provisions of section 6698 should encourage timely filing of information returns by syndicated partnerships, they have created confusion regarding the filing requirements of smaller partnerships. This is because the Act's legislative history seems to indicate that small partnerships do not have to file partnership returns at all. For example, the Senate report indicated:

The committee understands that small partnerships (those with 10 or fewer partners) often do not file partnership returns, but rather each partner files a detailed statement of his share of partnership income and deductions with his own return. Although these partnerships may technically be required to file partnership returns, the committee believes that full reporting of the partnership income and deductions by each partner is adequate and that it is reasonable not to file a partnership return in this instance.

In addition, the House Conference Report stated that "[s]maller partnerships (those with 10 or fewer partners) will not be subject to the penalty under this reasonable cause test so long as each partner fully reports his share of the income, deductions and credits of the partnership."

As this legislative history indicates, small partnerships, as well as informal partnerships (e.g., family farm partnerships), are technically required to file partnership returns. This requirement may impose an onerous burden on members of such partnerships when the partnership does not keep such formal business records as a balance sheet. Although the legislative history seems to justify small partnerships in not completing information returns, it is likely that the Service will still require even informal partnerships to complete these returns. Otherwise, the partnership could avoid the limitations the Code places on investment tax credit on used property and additional first year depreciation at the partnership level.

The Service should clarify this filing requirement as it affects small partnerships. Arguments can be made that family farm and ranch partnerships should be exempt from filing returns, because: 1) farming and ranching partnerships are not primarily organized

93. I.R.C. § 6698(b)(1)-(2).
94. I.R.C. § 6698(a)(2).
97. It is common for family members in an informal partnership to segregate their income and expenses informally and record their shares on their individual tax forms and personal financial statements.
as tax shelters;\textsuperscript{98} 2) farmers and ranchers have been allowed a simpler system of accounting for taxable income through the cash method because of the peculiar nature of their business;\textsuperscript{99} and 3) requiring farmers and ranchers to comply with the requirements of section 6698 would unnecessarily complicate their business records requirements and greatly increase expenses. Provisions enacted primarily to help identify and eliminate abusive tax shelters should not unduly prejudice other taxpayers who do not form partnerships to shelter income.

3. Statute of Limitations

The penalties imposed for not filing complete partnership returns most likely will encourage greater compliance with filing requirements, especially by large partnerships. However, Congress enacted another provision in the 1978 Revenue Act which seeks to assure that even those partners in tax shelters which do not file timely information returns in spite of the penalties, will not be able to evade liability for adjustments made at the partnership level.\textsuperscript{100} This was accomplished by extending the statute of limitations on the time within which the Service may assess a deficiency, attributable to partnership items, to an individual partner. It also liberalizes the rules under which the Service may obtain waivers of the statute of limitations for partnership items. These changes to the statute of limitations will insure that adjustments made at partnership level audits will be reflected at the partner level as well. The first change is an extension of the period the Service has to make adjustments to partner returns. Before the change the Service had three years from the date the tax return was filed.\textsuperscript{101} Even though a taxpayer was a member of a partnership, the filing of an individual tax return began the three-year statute of limitations, regardless of when the partnership return was filed, if at all.\textsuperscript{102} Because of this and other previously discussed problems inherent in the partnership audit,\textsuperscript{103} Congress decided to extend the limitations period and to change the incident which triggers the beginning of the period.\textsuperscript{104} The Code now provides that the Service may assess

\begin{itemize}
\item \textsuperscript{98} D. Kelley \& D. Ludtke, Estate Planning for Farmers and Ranchers \S 1.19 (1980). \textit{But see} Allington, Farming as a Tax Shelter, 14 S.D. L. Rev. 181 (1969).
\item \textsuperscript{100} I.R.C. \S 6501(q).
\item \textsuperscript{101} I.R.C. \S 6501(a).
\item \textsuperscript{103} \textit{See} notes 71-81 \& accompanying text \textit{supra}.
\end{itemize}
a partner for a deficiency attributable to partnership items within four years after the partnership return is filed,105 instead of within three years after the partner's individual return is filed. Additionally, if the partnership return is incomplete, in that it lacks the name and address of any partner, the statute of limitations does not expire with respect to the unreported partner until one year after such information is finally provided by the partnership.106

The second significant change by the Act affected the waiver of the limitations period. Prior to the 1978 Revenue Act, each partner had to agree personally to waive the limitations period. Consequently, the Service had to either find each partner and obtain a waiver or, if the partner refused, issue a deficiency letter before the partnership audit was completed.107 To streamline this process, the 1978 legislation provided that extensions, "insofar as they relate to partnership items, may, with respect to any person, be consented to . . . by a general partner of the partnership, [unless the partnership informs the Service that he has no such power] or by any person authorized to do so by the partnership in writing."108

This provision makes it essential that the partnership predetermine who, if anyone, should be authorized to waive other partners' statutes of limitations for partnership items. This is important because of the impact the general partner could have on each partner's individual tax liability by waiving these limitation periods. A determination of who should have this power should be based on a full disclosure of each partner's investment activities to insure that the general partners' interests in the partnership are as similar as possible to those of the limited partners. If it is decided that the general partner should not have this power, then notice must be given to the Treasury Secretary to insure that he cannot exercise it.

These provisions were enacted specifically because of the perceived problems inherent in abusive tax shelters.109 But, unlike

---

105. IRC. § 6501(q)(1)(A).


107. See notes 79-80 & accompanying text supra.


109. The House Report noted the reason for the change:

The number of large partnerships (those with over 50 partners) in-
the penalty provisions, these substantive changes were limited specifically to the types of partnerships which are most likely to be abusive tax shelters, i.e., federally registered partnerships.\textsuperscript{110} Federally registered partnerships are those which must be registered with, or are subject to, the annual reporting requirements of the Securities and Exchange Commission.\textsuperscript{111} Thus, most large and complex shelters which use the partnership form as a vehicle for tax savings will be subject to the new provisions relating to the statute of limitations. But those partnerships which are smaller and have no tax shelter motives still will be subject to the shorter three-year limitations period.\textsuperscript{112} This distinction is well justified and represents a more careful drafting than the more general approach enacted in the penalty section.

C. Unified Administrative and Judicial Proceedings

Since the enactment of the 1978 Revenue Act, there have been additional proposals to change the Service's audit process to more clearly reflect the entity concept. Legislation is being proposed to accomplish this.\textsuperscript{113} Willis suggests that if the problems of administration and "conflicts of interest as between partners"\textsuperscript{4} can be overcome, then making an administrative hearing at the partnership level binding on the partners would result in "some reduction... The Committee believes that the period of limitations in the case of large tax shelter partnerships should not commence until a partnership return identifying the partners is properly filed. In addition, the Committee believes that in these situations the period of limitations with respect to partnership items should be extended for an additional year.


LR.C. § 6501(q) is entitled: "Special rules for partnership items of federally registered partnerships."


See 1 A. Willis, supra note 1, at § 6.19 (Supp. 1980). Willis wrote that "[c]urrently the Internal Revenue Service and the Treasury Department are working on the development of proposed legislation to make it possible (or perhaps mandatory) that partnership taxation issues be determined in a single proceeding." \textit{Id}.

114. \textit{Id.} See a discussion of some of these problems in § II-B of the text \textit{supra}.

\textsuperscript{110} I.R.C. § 6501(q) is entitled: "Special rules for partnership items of federally registered partnerships."

\textsuperscript{111} I.R.C. § 6501(q)(4)(A)(B).

\textsuperscript{112} "These special periods of limitation for assessments or claims for refund of taxes attributable to partnership items are in addition to, and not a replacement of, the periods of limitations provided in present law." H.R. Rep. No. 1445, 95th Cong., 2d Sess. 77, reprinted in [1978] U.S. Code Cong. & Ad. News 7046, 7112.

\textsuperscript{113} See 1 A. Willis, supra note 1, at § 6.19 (Supp. 1980). Willis wrote that "[c]urrently the Internal Revenue Service and the Treasury Department are working on the development of proposed legislation to make it possible (or perhaps mandatory) that partnership taxation issues be determined in a single proceeding." \textit{Id}.

\textsuperscript{114} \textit{Id.} See a discussion of some of these problems in § II-B of the text \textit{supra}.
in tax litigation and some speeding up of the judicial process . . . .”115 The current backlog of partnership audits and litigation was also the concern of a proposal published by the American Bar Association in 1979. The proposal, formulated by the section on taxation, indicated:

The simple fact is that traditional rules and procedures do not readily lend themselves to the audit of books and records of investment partnerships who have varied interests, are scattered across the country, and whose very likely common bond with each other is only the investment in a particular enterprise.

The results are predictable. Disputes rage on endlessly, reconciliation of differing views is virtually impossible, backlogs and frustration build up, judicial calendars are clogged, and an important part of the tax administration system is threatened.116

The ABA proposal pointed out “that the backlog of returns now held in suspense by the Service because of unresolved partnership issues exceeds 100,000, or that about ten percent of all cases pending before the U.S. Tax Court reflect a dispute over the treatment to be accorded partnership issues.”117 Although some of the recommendations proposed to minimize these problems are essentially identical to those adopted by the 1978 Revenue Act (suggesting that they were prepared during consideration of the Act), the most sweeping proposals advocate the creation of a unified administrative proceeding118 and a unified judicial proceeding.119 In general, the proposals are similar to those the Carter Administration initially tried to enact in 1978.120 The partnership and partners would be bound in any administrative proceeding following the audit of the partnership. Either a general partner or other designated partner would act on behalf of the partnership in such proceedings.121 However, “[i]ndividual partners and real

115. 1 A. WILLIS, supra note 1, at § 6.19 (Supp. 1980). The Service has issued tax instructions for speeding tax shelter cases through appeals and trial. See I.R.M. Supp. 42G-404 (Jan. 31, 1980). Portions of the tax shelter program relating to review function and the appellate division issued in 1977 were not later incorporated into the manual in 1980. These sections provided that tax shelter cases were to be selected for mandatory review and allowed for appellate consideration within the Service if only one partner requested such action. It is likely that the backlog of cases required that such appellate consideration not be given in all requested situations. See I.R.M. Supp. 42G-376, §§ 3.04-.06 (Dec. 12, 1977).

116. Section of Taxation Proposals as to Audit of Partnerships, 32 TAX LAW. 551 (1979) [hereinafter cited as Tax Proposals].

117. Id.

118. Id. at 557-60.

119. Id. at 560-61.


121. Tax Proposals, supra note 116, at 557.
parties in interest would always have the right to participate in the administrative proceedings, including all conferences and appeals.” These partners would be given notice when such hearings were to take place.122

The ABA proposal also provided that a partner would be entitled to treat a partnership item on his individual return “different from that which it receives on the partnership return and his Form K-1.”123 However, if such treatment were elected, the partner would “be required to disclose the inconsistent treatment of the item on his individual tax return.”124 The proposal further provided that a “partner should also be allowed to dissent from any position reached between the Service and the designated partner, and . . . authorized to ask for a judicial review of any final administrative redetermination of partnership items.”125 The committee proposed that a special trial judge of the Tax Court be used in such an appeal process rather than adding this burden to the current Tax Court judges.126 Because the partner would have to ask for a review, the procedural burden would shift from the Service to the taxpayer. If no review is requested, “the administrative redetermination of partnership items reached by settlement between the government and the designated partner should become final ninety days after execution of the settlement agreement.”127

Even when the partnership and Service are unable to arrive at an agreement, the proposal recommended a “unified judicial proceeding in which any partner should be allowed to participate as a party.”128 However, if the designated partner refuses to initiate proceedings in a judicial forum, the proposal stipulated that “partners holding at least a 25 percent profit interest in the partnership should be authorized to challenge the administrative redetermination and to choose the forum in which to litigate.”129 Similarly, if after a court decision, the designated partner refuses to appeal, partners who “have a significant profit interest in the partnership—as much as 25-50 percent”—could require the partnership to appeal.130

Although this proposal would probably result in fewer individual partner returns being held in suspense and in less overlapping litigation, it might create other problems. The proposal might dis-

122. Id.
123. Id. at 558.
124. Id.
125. Id. at 559.
126. Id.
127. Id. at 560.
128. Id.
129. Id. at 561.
130. Id.
courage compromise at settlement procedures, because the Service would only have to make one settlement and would be unwilling to take into consideration the comparative size of the partnership items of individual taxpayers before subjecting them to time-consuming administrative procedures.\textsuperscript{131} Those who see the use of tax shelters as abusive would argue that audits of partnership activities should not depend upon other considerations. On the other hand, the threat of administrative and judicial appeals by partners dissatisfied with adjustments made at the partnership audit still might force Service to consider partners' individual situations before making final determinations of tax liability.

Another potential problem which could result from the proposal is that the general partner, or other partners representing the partnership, might not represent the best interests of all the partners and might succumb too easily to Service pressure. While this is already true under current law with respect to the waiver of partners' statutes of limitations, the ABA proposal would give the partnership representative even more discretion.

The portion of the proposal requiring that a certain percentage of the partnership jointly initiate judicial proceedings or appeal from such proceedings, when the partnership representative refuses to do so, also creates some difficulties. It would eliminate the right of some taxpayers (if they were unable to muster the required percentage) to challenge a determination of a portion of their tax burden.\textsuperscript{132} Although this procedure conceivably could help eliminate expense to the partnership when a sizable minority of the partners decline to incur litigation costs,\textsuperscript{133} an individual taxpayer, whose tax burden is being determined, would be denied an opportunity to appeal an administrative determination on the partnership level. Although a partner could still, presumably, appeal his own individual tax liability from partnership activities, the prior determination made at the partnership level could be prejudicial to his case. Even though the practice of making an initial administrative determination at the partnership level is justified because of the great administrative burden of syndicated partnerships on the Service, there should be no limitations placed on an individual partner's right to appeal these determinations on either the administrative or judicial levels.

\textsuperscript{131} See note 84 & accompanying text \textit{supra}.

\textsuperscript{132} See note 86 & accompanying text \textit{supra}.

\textsuperscript{133} See note 85 & accompanying text \textit{supra}.
IV. CONCLUSION

There is no doubt that the use of tax shelters will continue to be controversial. As new devices considered "abusive" by the Service are developed by inventive tax planners, the tax shelter program will be used to quickly identify and reverse the tax benefits claimed by investors. These investors will in turn continue to take every opportunity to challenge the Service's definition of "abusive" by seeking administrative and judicial review. Current proposals to make appeals at the partner and partnership levels more difficult, so that partners will have to abide by partnership-level adjustments, may have suffered a setback with the elevation of a former investment company chief to head the Treasury Department.134 One man's definition of "abusive" is another man's conception of "fair incentive."135 Thus, the battleground of tax shelter audits may well shift to other fronts.

Other major auditing problems will become more troublesome for the Service. One problem the Service is beginning to emphasize in its tax shelter program is the identification of burned-out tax shelters. Prior to the December 1980 incorporation of the supplement outlining the tax shelter program into the Internal Revenue Manual, no mention was made of burned-out shelters in the program's purposes or organization. However, the program now outlined in the manual mentions them eight times. It states not only "[p]articular efforts will be directed to identifying burned-out shelters and assuring that participants have properly recaptured any reportable income," but also that these shelters are "potentially abusive even though large losses are not being claimed" because of the "deferred tax consequences involved."136 Special emphasis is also given to burned-out shelters in describing the duties of the assistant regional commissioner, district director, Examination Division chief, and group or case managers.

Obviously the Service is concerned that investors who can no longer claim loss deductions, either because their shelters have reached the cross-over point or have become insolvent, will simply walk away from their investments, rather than report recapture items or taxable income in excess of cash flow.137 This would be a tempting solution, particularly for taxpayers who, at the time of their investment, may have been unaware of the problems associ-

134. Donald Regan was nominated and confirmed as Secretary of Treasury in the Reagan Administration. He is the former CEO of Merrill Lynch, an investment broker which is active in promoting tax shelters.
135. See Administrative Views, supra note 6, at 191.
137. For a short discussion of the cycle of a tax shelter, see 2 W. McKee, W. Nelson & R. Whitmire, supra note 1, ¶ 18.01.
ated with a mature tax shelter, especially if they have tried to bail out "legally" and have found that it is impossible to do so. It will be interesting to see what methods the Service develops to identify the owners of burned-out shelter interests who attempt to walk away from them. The current classification system would not help unless a partnership return is filed. In cases of real abuse, some partnerships may decide to disband to avoid increased liability. If such a practice became widespread, the Service might attempt to monitor investors who have taken large loss deductions through tax shelter investments. However, such an effort would be monumental and reminiscent of the Service's early tax shelter program, which attempted to locate abusive tax shelter practices at the partner level. In addition, it could have the effect of tainting investors who have not attempted to avoid tax liability and subject them to excessive and time-consuming audits. The Service should avoid this result by enforcing filing requirements at the partnership level and by monitoring compliance. Such an approach would be consistent with the present auditing program.

The burned-out shelter is only one of many problems which will continue to complicate enforcement of tax laws vis-a-vis tax shelters. While its solution may lie in the identification of tax abusers and adjustment of liability at the partnership level, care must be taken to preserve the rights of investors to argue, appeal, and litigate. Although allowing the taxpayer these rights may result in overlapping litigation and greater administrative burden, it will also avoid the unfairness inherent in any proposal which unduly disadvantages the individual, who ultimately bears the burden of taxation.

Michael W. Homer '81