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UNITED STATES TAX COURT
WASHINGTON, DC 20217

LARRY S. FREEDMAN & SHERI L. FREEDMAN,	)	
Petitioner(s),	)	
v.	)	Docket No. 23410-14.
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent	)	

O R D E R

The present case concerns a notice of deficiency that respondent issued to petitioners for their taxable year ended December 31, 2000. The adjustments in the notice of deficiency relate to Mr. Freedman's indirect investment in a partnership, Pinnacle Trading Opportunities, LLC (Pinnacle).[1] Respondent has filed a motion to dismiss for lack of jurisdiction "so much of this case as is based upon the

[1]Mr. Freedman held his interest in Pinnacle through a limited liability company (LLC) of which he was the sole member and a trust of which he was both grantor and sole beneficiary. The record provides no indication that the LLC elected to be classified as an association (i.e., corporation) for Federal income tax purposes. And the trust reported itself to be a grantor trust. Therefore, we assume that Mr. Freedman was properly treated for Federal income tax purposes as owning the assets held by the trust and the LLC. See secs. 671-679 (treating grantors as owners of trust assets in specified circumstances); sec. 301.7701-3(b)(1)(ii), Proced. & Admin. Regs. (providing that a domestic "eligible entity" with a single owner that does not elect otherwise is "[d]isregarded as an entity separate from its owner"). (All section references are to the Internal Revenue Code in effect for 2000.) In the interest of simplicity, we will describe Mr. Freedman's interest in Pinnacle as a directly held interest.

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application of penalties attributable to * * * [Pinnacle's] partnership items". For the reasons explained below, we will deny respondent's motion.

Background

In a prior partnership-level case, Pinnacle Trading Opportunities, LLC v. Commissioner (Docket No. 19291-05), we granted the Commissioner's motion for entry of decision, which Mr. Freedman, who filed the petition for readjustment on Pinnacle's behalf, did not oppose. In our Order & Decision in the partnership case, we decided that "Pinnacle is disregarded as a partnership for Federal income tax purposes and that all transactions purportedly engaged in by Pinnacle are treated as directly engaged in by the partners of Pinnacle". We also redetermined to be zero the following amounts the partnership reported for 2000: capital contributions (reported as $2,500), other income (reported as $81,435,824), deductions for operating expenses and interest (reported as $817,382), distributions of money (reported as $389,803), and distributions of property other than money (reported as $601,567). Finally, we "determined that a 40 percent gross valuation misstatement penalty under § 6662(a), (b)(3), (e) and (h), I.R.C., applies to all underpayments of tax related to the misstatement of partnership contributions reported to have been made to Pinnacle."

Just shy of one year following our Order & Decision in Pinnacle's partnership case, respondent issued to petitioners the notice of deficiency that gave rise to the present case. Cf. sec. 6229(d)(2) (suspending period of limitations for assessing deficiencies attributable to partnership items for one year following final court decision on petition for readjustment). The deficiency respondent determined reflects his disallowance of (1) a loss petitioners claimed from Mr. Freedman's disposition of euros that he received as a liquidating distribution from Pinnacle (net of Mr. Freedman's share of Pinnacle's reported other income), (2) Mr. Freedman's distributive share of Pinnacle's operating expenses, and (3) a deduction of $22,500 for investment management fees that did not flow through from Pinnacle.[2] The notice of deficiency also determined a gross valuation misstatement penalty under section 6662(a), (b)(3), (e) and (h) equal to 40% of the full amount of the deficiency.

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[2]Petitioners claimed no deduction for investment interest on the Federal income tax return they filed for 2000. We assume that their failure to claim a deduction for Mr. Freedman's share of Pinnacle's interest expense was attributable to the limitation on the deductibility of investment interest provided in sec. 163(d).

The TEFRA Partnership Audit and Litigation Rules

The partnership audit and litigation rules originally enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and in effect for partnership taxable years beginning before 2018 require, when applicable, that tax items related to a partnership be determined in a unified partnership-level proceeding. The Commissioner cannot collect from the partnership's partners any increases to their tax liabilities resulting from adjustments to the partnership's reported items until after the completion of the partnership-level proceedings. Sec. 6225(a). The procedures for assessment and collection differ, however, depending on whether the partner's liability resulting from a partnership-level adjustment depends on facts specific to that partner that were not determined in the partnership proceeding.

If the impact on a partner of adjustments to partnership items is purely computational, and can be determined without partner-level determinations, the Commissioner can assess liability without recourse to the deficiency procedures of sections 6211 through section 6216. Section 6230(a)(1) provides as a general rule that the deficiency procedures "shall not apply to the assessment of any computational adjustment". And section 6231(a)(6) defines "computational adjustment" to mean "the change in tax liability of a partner which properly reflects the treatment * * * of a partnership item".

By contrast, if the partner's liability resulting from a partnership-level adjustment depends on partner-specific facts, the Commissioner cannot assess a deficiency without first issuing a notice of deficiency, thereby giving the partner the ability to contest the deficiency before this Court in advance of payment. Section 6230(a)(2) provides exceptions to the general rule allowing the assessment and collection of computational adjustments without deficiency procedures. One of those exceptions applies (and thus requires that deficiency procedures be followed) in the case of "any deficiency attributable to * * * affected items which require partner level determinations". Sec. 6230(a)(2)(A)(I). ("Affected items" are items that, while not themselves partnership items, are affected by partnership items. Sec. 6231(a)(5).)

Rules enacted in 1997 allow penalties attributable to partnership items to be determined in partnership-level proceedings and assessed and collected without deficiency procedures, requiring partners to assert any partner-level defenses to the penalty only after paying it and filing suit for a refund. Section 6221, as amended in 1997, requires the determination at the partnership level of not only partnership

items but also "the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item". By its terms, section 6230(a)(2)(A)(I), which generally requires deficiency procedures for deficiencies attributable to affected items that require partner level determinations, does not apply to "penalties, additions to tax, and additional amounts that relate to adjustments to partnership items".

The Parties' Arguments

In support of his motion, respondent argues: "The Court does not have jurisdiction over the 40% penalty imposed under I.R.C. § 6662. The applicability of the penalty was determined in the decision entered in the related partnership-level proceeding. This Court lacks jurisdiction in a partner-level proceeding to consider penalties that relate to partnership items."

In response, petitioners contend: "This individual deficiency proceeding is the proper venue for Mr. Freedman to prove his reasonable cause and good faith defense to the asserted penalties which are based on non-partnership items, such as outside basis". They further claim that "the calculation of * * * any deficiency-based penalty" must take into account "[t]he gain or loss on the sale of the Euros" that Mr. Freedman received as a liquidating distribution from Pinnacle. Finally, petitioners suggest that depriving them the opportunity to assert in this proceeding their partner-level defenses to the penalty respondent determined would violate their due process rights under the Fifth Amendment to the U.S. Constitution.

Analysis

Respondent's ability to collect the penalty he determined in the notice of deficiency as a computational adjustment without deficiency procedures depends on whether the penalty "relates to" an adjustment to a partnership item we made in the prior partnership proceeding and whether the penalty is "based on" the determinations we made in that proceeding. Section 301.6231(a)(6)-1T(a)(2), Proced. & Admin. Regs., provides that "any penalty, addition to tax or additional amount that relates to an adjustment to a partnership item may be directly assessed following a partnership proceeding, based on determinations in that proceeding, regardless of whether partner level determinations are required." Our Order & Decision in Pinnacle's partnership case redetermined to be zero the capital contributions reported as $2,611,840 for 1999 and $2,500 for 2000. Because the reported contributions exceeded the redetermined amounts by 400% or more, see sec. 1.6662-5(g), Income Tax Regs. ("The value or adjusted basis claimed on a

return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount."), we further "determined that a 40 percent gross valuation misstatement penalty * * * applies to all underpayments of tax related to the misstatement of partnership contributions reported to have been made to Pinnacle."

Therefore, respondent can collect the penalty he determined in the notice of deficiency as a computational adjustment apart from the present case only if he establishes that the penalty "relates to" our redetermination of the capital contributions made to Pinnacle and is "based on" our determination that the reported contributions were overstated by at least 400%. Respondent has not made the showing required for us to grant his motion to dismiss the portion of the case involving petitioners' request for a redetermination of the penalty respondent determined.

The capital contributions that the Commissioner asked us to redetermine to be zero in Pinnacle's partnership case had no obvious bearing on the tax consequences of the partnership's activities. The $2,611,840 capital contributions Pinnacle reported for 1999 appear on its Form 1065, U.S. Return of Partnership Income, only on line 2 of Schedule M-2, Analysis of Partners' Capital Accounts--a line captioned "Capital contributed during year". (We assume that Pinnacle's much smaller capital contributions for 2000 (only $2,500) were similarly reported.) If Pinnacle maintained capital accounts in accordance with section 1.704-1(b)(2)(iv), Income Tax Regs., it would have credited the partners' capital accounts with the fair market value of the property they contributed to the partnership. See sec. 1.704-1(b)(2)(iv)(d)(1), Income Tax Regs. ("The basic capital accounting rules contained in paragraph (b)(2)(iv)(b) of this section require that a partner's capital account be increased by the fair market value of property contributed to the partnership by such partner on the date of contribution."). That capital account credit, however, served to determine the partners' economic entitlements. The partnership's compliance (or not) with the capital account maintenance rules might have affected whether its allocation of distributive share items among its partners would be respected for tax purposes. See sec. 704(b); sec. 1.704-1(b)(2)(ii)(b)(1), Income Tax Regs. But the adjustments made in the Commissioner's notice of final partnership administrative adjustment, and upheld in the prior partnership-level case, rested on grounds other than a misallocation of items among Pinnacle's partners. In Arbitrage Trading, LLC v. United States, 108 Fed. Cl. 588, 603-604 (2013), the court noted that, because "a partnership's contributions and distributions are capital account entries," the adjustment of those items "do[es] not create an underpayment of tax to which a penalty could apply".

The deficiency respondent determined, and to which he seeks to apply a 40% gross valuation misstatement penalty, reflects (among other things) a disallowance of the loss petitioners reported from Mr. Freedman's sale of the euros he received as a liquidating distribution from Pinnacle. We assume that the basis Mr. Freedman claimed as an offset to his amount realized from his sale of the euros equaled the outside basis he claimed to have in the partnership interest in exchange for which he received the euros. See sec. 732(b) ("The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction."). Thus, respondent's disallowance of petitioners' claimed loss reflects the premise that, because of our prior determination disregarding Pinnacle as a partnership, Mr. Freedman's basis in the euros was not determined by section 732(b) (and, as a consequence, did not exceed Mr. Freedman's amount realized from their sale). But because our Order & Decision in the prior partnership proceeding did not determine Mr. Freedman's correct basis in the distributed euros,[3] we also did not determine (and could not have determined) that the basis Mr. Freedman claimed as an offset to his amount realized from the sale of the

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[3]We did not determine Mr. Freedman's correct basis in the distributed euros in our Order & Decision in Pinnacle's partnership case because the decision respondent asked us to enter, without Mr. Freedman's objection, did not include such a determination. The omission from our Order & Decision of a determination of Mr. Freedman's basis in the distributed euros did not reflect the limits on our jurisdiction in the partnership case. Because we determined that Pinnacle was disregarded as a partnership, we had jurisdiction under sec. 301.6233-1T(a), Temporary Proced. & Admin. Regs., to determine those of Pinnacle's items that would have been partnership items had we recognized Pinnacle as a partnership. If Pinnacle had been recognized as a partnership, it would be have been required to provide Mr. Freedman with information about the distributed euros, including their adjusted basis. See sec. 301.6231(a)(3)-1(c)(3)(iii), Proced. & Admin. Regs. Therefore, the basis of the euros that Pinnacle, being disregarded, necessarily held as agent for Mr. Freedman was a partnership item "by analogy to section 301.6231(a)(3)-1(c)(3)(iii), Proced. & Admin. Regs." See Tigers Eye Trading, LLC v. Commissioner, 138 T.C. 67, 148-149 (2012) (Halpern, J., concurring), aff'd in part, rev'd in part, and remanded sub nom. Logan Trust v. Commissioner, 616 F. App'x 426 (D.C. Cir. 2015). In short, although we did not determine in Pinnacle's partnership case Mr. Freedman's basis in the distributed euros, we could have.

euros was overstated by at least 400%. Cf. sec. 6662(h)(2) (defining "gross valuation misstatements").

It may be that, in asking us to redetermine to be zero the capital contributions made to Pinnacle in the decision entered in Pinnacle's partnership case, the Commissioner was referring not to the capital account credits allowed for the contributions (and reported on Schedule M-2 of its Forms 1065), but instead to the partnership's "inside" basis in the contributed property. Even under that interpretation of our Order & Decision in Pinnacle's partnership case, however, it would not follow that the penalty respondent determined in the notice of deficiency was based on our Order & Decision. Because a partnership's inside basis in contributed property and the outside basis of a partnership interest issued in exchange for the property are both determined by reference to the partner's pre-contribution basis in the property, secs. 722, 723, a determination that the partnership overstated its inside basis in the property would indicate that the partner's initial outside basis was also overstated. If Mr. Freedman overstated his initial outside basis in his interest in Pinnacle, it would tend to follow that he also overstated the basis of the euros he received from the partnership in liquidation of that interest. But Mr. Freedman's correct basis in the euros (in contrast to the redetermined capital contributions and partnership inside basis) was almost certainly higher than zero. Therefore, a determination that Pinnacle's basis in the property Mr. Freedman contributed was zero (or, more precisely, did not exist) would not establish that Mr. Freedman's claimed basis in the distributed euros was overstated by at least 400%.

The other adjustments in the notice of deficiency have even less apparent connection to the overstatement of the capital contributions made to Pinnacle. In fact, the investment management fees for which petitioners claimed a deduction did not flow through from Pinnacle. Although the disallowed deduction for Mr. Freedman's share of the partnership's operating expenses was a flow-through item, respondent has not explained the relationship between the overstatement of those expenses and the overstatement of contributions.

Respondent's reliance on United States v. Woods, 571 U.S. 31 (2013), is misplaced. In that case, the Court held that "TEFRA gives courts in partnership-level proceedings jurisdiction to determine the applicability of any penalty that could result from an adjustment to a partnership item, even if imposing the penalty would also require determining affected or non-partnership items such as outside basis." Id. at 41. Thus, Woods confirmed our ability, in Pinnacle's partnership case, to determine a gross valuation misstatement penalty on any underpayments

attributable to the overstatement of capital contributions made to the partnership. But Woods does not establish that the penalty respondent determined in the notice of deficiency is the penalty we determined in Pinnacle's partnership case. More generally, the question of the procedures required to assess and collect penalties provisionally determined in a partnership proceeding was not before the Court in Woods.

Conclusion

For the reasons explained above, it is

ORDERED that respondent's motion to dismiss for lack of jurisdiction is denied. It is further

ORDERED that on or before August 20, 2018, the parties are directed to submit decision documents or dispositive motions or, in lieu thereof, file a joint or separate status reports to inform the Court of the then present status of the above case.

(Signed) James S. Halpern
Judge

Dated: Washington, D.C.
July 20, 2018