UNITED STATES TAX COURT
WASHINGTON, DC 20217

ERNEST S. RYDER & ASSOCIATES, INC., APLC, ET AL.,		
Petitioner(s),		
v.	Docket No.	14619-10, 14687-10, 7527-12, 9921-12, 9922-12, 9977-12, 30196-14, 31483-15.
COMMISSIONER OF INTERNAL REVENUE,		
Respondent		

ORDER

These cases were tried in two special trial sessions in 2016: one in San Diego from July 25 to August 3, and another in Phoenix from August 22 to August 26. The Commissioner has already filed his opening brief; Ryder's answering brief and the Commissioner's reply are due later this year. Before trial Ryder filed a motion *in limine* and a motion to dismiss for lack of jurisdiction. These motions are essentially identical. The Commissioner responded to them last July. We've already denied them as moot for docket numbers 28200-11, 7537-12, 9497-12, 9920-12, 9976-12, 10759-12, and 12750-12. We now decide them for the remaining cases.

Ryder says we don't have jurisdiction over some of the issues in these cases because they would have us determine partnership items the Court can address only through the unified audit and litigation provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, secs. 401-406, 96 Stat. at 648-70, codified in I.R.C. §§ 6221 to 6234. The primary issues the parties address are whether funds that passed from a C corporation through partnerships are constructive dividends or otherwise income to the Ryders, whether the Ryders have sufficient basis in those partnerships to take flow-through losses, and whether certain losses were from passive activities and could therefore only offset passive income. The Commissioner says these issues either aren't partnership items or the relevant entities aren't subject to TEFRA for the years at issue.

Tax Court Jurisdiction

We are a court of limited jurisdiction. I.R.C. § 7442; *see also, e.g.*, *GAF Corp. & Subs. v. Commissioner*, 114 T.C. 519, 521 (2000). If a taxpayer who receives a valid NOD files a

timely petition with us, we can redetermine any deficiency for tax years that NOD addresses. I.R.C. §§ 6212(a), 6213(a), 6214. We can usually also make factual findings related to other tax years if we need them to redetermine the deficiencies before us. I.R.C. § 6214(b).

It's more complicated when a TEFRA partnership is involved. A TEFRA partnership is a partnership that has more than ten members; has members that aren't individuals, C corporations, or estates of deceased partners; or elects to be a TEFRA partnership. I.R.C. § 6231(a)(1)(B)(i)-(ii). The Commissioner uses the partnership's return to determine whether a partnership is a TEFRA partnership. I.R.C. § 6231(g).

TEFRA has long forced us to distinguish those items that we can adjust in a partnership-level case from those we can only adjust in a partner-level case. *See* I.R.C. § 6221; *Ginsburg v. Commissioner*, 127 T.C. 75, 79 (2006); *GAF Corp. & Subs.*, 114 T.C. at 521. A partnership item is "any item required to be taken into account for the partnership's taxable year * * * to the extent regulations * * * provide that * * * such item is more appropriately determined at the partnership level than the partner level." I.R.C. § 6231(a)(3); *see also* 26 C.F.R. § 301.6231(a)(3)-1; *Ginsburg*, 127 T.C. at 79; *Estate of Quick v. Commissioner*, 110 T.C. 172, 183 (1998). In contrast, a nonpartnership item is "an item which is (or is treated as) not a partnership item." I.R.C. § 6231(a)(4); *Estate of Quick*, 110 T.C. at 183.

It's even more complicated if the nonpartnership item is *affected* by the determination of a partnership item. The Commissioner can only adjust an "affected item" in an NOD if he accepts the partnership's return as filed or partnership-level proceedings are over.[1]

Ginsburg, 127 T.C. at 83; *GAF Corp. & Subs.*, 114 T.C. at 526-28. An NOD issued before partnership-level proceedings are over is invalid for any affected items, meaning we don't have jurisdiction over those items -- even if the NOD was issued after the Commissioner sent the partnership a notice of final partnership administrative adjustment (FPAA). *GAF Corp. & Subs.*, 114 T.C. at 526-28.

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[1] The Ninth Circuit says an NOD is valid for affected items even if the Commissioner doesn't expressly accept a partnership return as filed, so long as no partnership proceedings are pending. *See Meruelo v. Commissioner*, 691 F.3d 1108, 1117-19 (9th Cir. 2012), *aff'g* 132 T.C. 355 (2009).

What are the partnership items?

TEFRA's limitations on our jurisdiction don't necessarily mean that Ryder wins his motion. The Commissioner concedes that one issue Ryder raised is a TEFRA partnership item that we lack jurisdiction to determine in these cases: Whether Coventry Motorcars, Ltd. was operated for profit in tax years 2005, 2006, and 2007. (The Commissioner says the Ryders still can't take losses from this business, though, because they haven't substantiated their basis in it and don't have sufficient passive income; more on that below.) But he argues that other issues Ryder thinks we can't consider -- income from Ryder & Associates, outside basis, and passive losses -- either aren't partnership items or the partnerships they involve aren't TEFRA partnerships. We look at each.

Income from Ryder & Associates

In an NOD he sent to the Ryders, the Commissioner said he'd determined that First Counsel Capital, LLC was a disregarded entity for federal tax purposes in 2005 and 2006 and increased the Ryder's income accordingly. In his amended answer, he alleged more broadly that Ryder funneled income of Ryder & Associates, a C corporation that he owned, through First Counsel Capital and then into Ryder Ranch Company, LLC, which used the funds to buy personal assets for the Ryders. The Commissioner argues that these funds were constructive dividends to the Ryders.

Ryder argues that this means that the Commissioner is really alleging that First Counsel Capital is a sham. He is correct that whether a partnership is a sham is a partnership item that we can't decide in a partner-level proceeding -- if the partnership is governed by TEFRA. *See United States v. Woods*, 571 U.S. __ , __, 134 S. Ct. 557, 564 (2013); *Napoliello v. Commissioner*, 655 F.3d 1060, 1065 (9th Cir. 2011), *aff'g* 97 T.C.M. 1536 (2009). And this is exactly the Commissioner's reply -- he says he doesn't care if First Counsel Capital is a sham or a real partnership because he reasonably determined that it wasn't a *TEFRA* partnership in 2005 and 2006. His argument is simple: First Counsel Capital didn't file returns for those two years and the returns it filed for other years showed that it wasn't a TEFRA partnership. On the evidence we have, he's right about this, or at least reasonable about this, which is all the Code requires. *See* I.R.C. § 6231(g). If First Counsel Capital wasn't a TEFRA partnership in any of the years it filed returns, concluding that it also wasn't a TEFRA partnership in years it didn't file is reasonable.

Moreover, we wouldn't have to find that First Counsel Capital was a sham to determine that Ryder & Associates funds that passed through it were constructive dividends to the Ryders. Constructive dividends occur when "a corporation provides an economic benefit to a shareholder with no expectation of reimbursement." *Benson v. Commissioner*, 560 F.3d 1133, 1134 (9th Cir. 2009), *aff'g* 91 T.C.M. 925 (2006). A payment doesn't have to go directly to the shareholder to be a constructive dividend -- it just has to "benefit[] the shareholder personally rather than further[] the interest of the corporation." *Muhich v. Commissioner*, 77 T.C.M. 2143, 2150 (1999), *aff'd*, 238 F.3d 860 (7th Cir. 2001). Whether First Counsel Capital was a sham is irrelevant.

First Counsel Capital isn't the only entity the Commissioner said was a "conduit" or "bucket" used to funnel income from Ryder & Associates to the Ryders; he said the same thing about Ryder Ranch, Ryder Investment Partners, and Coventry Motorcars, and he didn't limit that characterization to specific years. Ryder thinks this implicates all sorts of things that he argues are partnership items: the identity of partners, those partners' shares of partnership income and losses, their contributions, the partnerships' basis in contributed property, the ownership of partnership assets, and the deductibility of partnership expenses. But these things are irrelevant to the question of whether funds leaving a C corporation were income to Ryder. *See Watkins v. Commissioner*, 108 T.C.M. 337, 340 (2014) (where Commissioner agreed partnerships not shams and partnership distributions didn't go directly to petitioners, "[t]he fact that the funds may have at some point come from a distribution from [a partnership] does not make the petitioners' alleged use of the funds for personal gain necessarily a partnership item").

We therefore have jurisdiction over these issues.

Outside Basis

A partner's losses are limited to his basis in the partnership. I.R.C. § 704(d). The Commissioner says the Ryders haven't substantiated theirs for Ryder Ranch for 2007; Ryder Investment Partners for 2007; and Coventry Motorcars for 2005, 2006, and 2007. According to Ryder, we can't determine the Ryders' outside bases because we don't have jurisdiction to determine contributions to the partnership or the partnerships' bases in them.

The regulations and caselaw make clear that a partner's outside basis is an affected item. 26 C.F.R. § 301.6231(a)(5)-1(b); *Woods*, 571 U.S. at ___, 143 S. Ct. at 565; *Thompson v. Commissioner*, 729 F.3d 869, 873 (8th Cir. 2013), *rev'g* 137 T.C. 220 (2011). We therefore have jurisdiction over the issue of the Ryders' outside bases if the Commissioner accepted the relevant partnership returns as filed, any partnership proceedings were over when the Commissioner issued the NODs, or the entities weren't TEFRA partnerships. *See Ginsburg*, 127 T.C. at 83; *GAF Corp. & Subs.*, 114 T.C. at 526-28.

The Commissioner's position toward Ryder Ranch isn't crystal clear. First he tells us that it was a TEFRA partnership in 2003 through 2006. Then he points out that when he issued the NODs in these cases it hadn't yet filed a return for 2007, making it reasonable for him to determine that it wasn't a TEFRA partnership for that year. Then he says -- without telling us where to find it in the record -- that it filed a 2007 return in 2016 that listed only two individuals and a C corporation as members, which would mean it wasn't a TEFRA partnership.[2] Then he

[2] We found only two Schedules K-1 attached to that return -- one for Ryder and one for First Counsel Capital, Inc., which the schedule says is a partnership. Earlier in his motion the Commissioner said that First Counsel Capital filed a Form 1065 partnership return for 2003, filed no returns for 2004 through 2009, and filed Form 1120 corporate returns for 2010 and 2011, which we presume is somehow

says -- again without telling us where to find it in the record -- that a report Ryder Ranch made to a third party suggested it was a TEFRA partnership in 2007. Finally he says he accepted Ryder Ranch's 2007 through 2011 returns as filed -- presumably meaning the ones filed after the NODs.

We think the point is that in 2007 Ryder Ranch either wasn't a TEFRA partnership or the Commissioner accepted its return as filed, either of which means we have jurisdiction over affected items. *See Ginsburg*, 127 T.C. at 83.

The Commissioner concedes that Ryder Investment Partners, Ltd. was a TEFRA partnership in 2007 and that Coventry Motorcars was one in 2005, 2006, and 2007. But he accepted their returns as filed, so for these years we have jurisdiction over the Ryders' bases in these entities.

Passive Loss Limitations

The Commissioner disallowed passive losses that the Ryders claimed from Ryder Ranch for 2003 and 2004; Ryder Investment Partners for 2007; and Coventry Motorcars for 2005, 2006, and 2007. He said the losses were from a passive activity and the Ryders didn't have enough passive income to claim them against. I.R.C. § 469 (limiting passive losses to extent of passive income). Ryder acknowledges that in cases where no TEFRA proceedings are pending we have jurisdiction over whether the Ryders materially participated in a trade or business.

Indeed, "characterization of losses as either passive or nonpassive in the hands of a partner is an affected item under section 469." *Estate of Quick*, 110 T.C. at 188; *see also* 26 C.F.R. § 301.6231(a)(5)-1(d); *Ginsburg*, 127 T.C. at 82. It has to be, because "[d]etermining whether or not [taxpayers] materially participated in [an] activity for purposes of section 469 has no effect on any item that would affect all of the partners' respective returns, nor does it have any effect on any item on the Partnership's return or on the Partnership's books and records." *Estate of Quick*, 110 T.C. at 187; *see also Roberts v. Commissioner*, 94 T.C. 853, 861 (1990).

The Commissioner says that Ryder Ranch was a TEFRA partnership in 2003 and 2004, but he accepted its returns for those years as filed, so we have jurisdiction over affected items, including passive loss limitations. As discussed above, the Commissioner also accepted as filed Ryder Investment Partners' 2007 return and Coventry Motorcars' 2005, 2006, and 2007 returns, so we have jurisdiction to redetermine the Ryders' passive loss limitations for those entities in those years as well. *See Ginsburg*, 127 T.C. at 83.

At-Risk Loss Limitations

The Commissioner also mentions I.R.C. § 465's at-risk loss limitations in connection with Ryder Ranch. We don't address these here because Ryder didn't mention them in his

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his basis for saying it was a C corporation in 2007. We don't decide here which type of entity it was in 2007 because we don't need to to rule on this motion.

motion -- probably because the Commissioner didn't mention them in the NODs or amended answer. We note, however, that at-risk loss limitations are also affected items, so if they were before us we'd analyze them the same way we've analyzed outside basis and I.R.C. § 469 limitations. 26 C.F.R. § 301.6231(a)(5)-1(c).

It is therefore

ORDERED that petitioners' motion to dismiss is GRANTED as to the issue of whether Coventry Motorcars, Ltd. was operated for profit in 2005, 2006, and 2007. It is also

ORDERED that petitioners' motion to dismiss is DENIED as to all other issues. It is also

ORDERED that petitioners' motion *in limine* is DENIED as duplicative.

(Signed) Mark V. Holmes
Judge

Dated: Washington, D.C.
March 12, 2018