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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:

DONALD A. WATTSON AND
CHRISTINE A. WATTSON[1]

HEARING SUMMARY

PERSONAL INCOME TAX APPEAL

Case No. 446005

		Proposed Assessment
Year	Tax	Accuracy-Related Penalty[2]
2001	$273,149.00	$54,629.80

Representing the Parties:

For Appellants: Mr. James T. Burnes, Esq.

For Franchise Tax Board: Susanne E. Coakley, Tax Counsel

QUESTIONS: (1) Whether appellants received a taxable deemed distribution from a partnership of $3,257,815 in 2001.

(2) Whether the duty of consistency should bar appellants' contention that the amount at issue should have been applied to the 1995 or 1996 tax year.

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[1] Appellants reside in Newport Beach in the County of Orange.

[2] Respondent is also imposing the post-amnesty penalty for this year.

(3) Whether the accuracy-related penalty should be abated.

(4) Whether the Board has jurisdiction over the post-amnesty penalty in the context of this appeal.

HEARING SUMMARY

Background

The Wattson Company was formed as a partnership in the mid-1980s.[3] In 1991, The Wattson Company became Wattson Arno Company (WAC). Appellant-husband and Arno Investments, Inc. (ARNO) were the general partners in WAC.[4] WAC in turn was a partner in numerous real estate partnerships. According to the K-1s provided, appellant-husband owned 80 percent of the profit and loss interests and zero percent of the capital interest in WAC from 1986 to 1991, 65 percent of the profit and loss interests and zero percent of the capital interest from 1992 to 1995, 0 percent of the profit, loss and capital interests from 1996 to 1998, and then 40 percent of the profit, loss and capital interests for 1999 and 2000.[5] It appears that the 1984 WAC partnership agreement was not provided to respondent during the protest or audit, but was provided during this appeal (Appellants' Reply Br., Exhibit A.)

The WAC partnership agreement provides for appellant-husband to act as the Managing Partner of WAC, with ARNO as a general partner. (*Id.*, Exhibit A at 1.) According to the agreement, the Managing Partner was to be paid a monthly salary of $8,333, which could go higher depending on an understanding of the partners. (*Id.*, Exhibit A at 3.)[6] The Managing Partner was not obligated to contribute any money to the capital of the partnership. (*Id.*, Exhibit A § 3.1.) Although the partnership agreement stated that ARNO would be the 20 percent partner and appellant-husband the 80 percent

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[3] Respondent stated it was formed in 1986, whereas the partnership agreement later provided at appeal shows an effective date as of March 1, 1984.

[4] Respondent contends that appellants and ARNO may be related parties. Appellants' claim that ARNO's shareholder was Mr. Arthur Borie. (Appellants' Reply Br. at 2.)

[5] Respondent contends that appellants' ownership in WAC was higher in the years in which WAC had losses and for gain years Arno Investments, Inc. had a greater ownership interest. Forms K-1 for 1984 and 1985 were not provided.

[6] Based on the partnership agreement, it appears appellant-husband may have been providing real estate services for the partnership owning no capital interest in the partnership (as opposed to being an investing partner with a material capital account). At the oral hearing, appellants should be prepared to discuss the economics of the partnership arrangement, e.g., why appellant-husband's capital interests were so low and why his profit and loss interests were so high, by comparison.

partner, all losses attributable to cash contributions were allocated 50/50 among ARNO and appellant-husband in proportion to their capital contributions.[7] (*Id.*, Exhibit A § 4.3.) All gains/profit were first 100 percent allocated to appellant-husband until the aggregate amounts equaled the amount of losses and deductions allocated to him,[8] thereafter, all gains/profit would be allocated 20/80 to ARNO and appellant-husband, respectively. Upon liquidation, deficit capital account balances had to be paid to the partnership and then distributed in accordance with the partnership's liquidation rules. (*Id.*, Exhibit A § 5.4.)

According to an undated reorganization agreement, entered into as of July 14, 1995, the WAC partnership agreement was modified. (Appellants' Reply Br., Exhibit C.) Appellant-husband relinquished management and control over WAC to ARNO, which became the new managing partner. ARNO was to have a priority distribution of all available cash until all capital contributions and loans made by the Borie parties (the Borie Trust, Mr. Arthur Borie and ARNO (Mr. Borie was apparently the president of ARNO)) had been repaid in full with interest. ARNO could not dissolve the partnership until July 14, 2000, without the reasonable consent of appellant-husband. (*Id.* at 3.) The standard of reasonableness included withholding consent if a dissolution would cost in excess of $10,000 in tax to appellant-husband. After the July 14, 1995 effective date, appellant-husband no longer had an "obligation to make any contribution of capital or other financial commitment with respect to [WAC]." (*Id.*) Appellant-husband was to assume the following liabilities of WAC, which according to the reorganization agreement were all of the liabilities of WAC: (1) a $50,000 credit line, (2) a $25,000 promissory note, all outstanding payables, and (3) the obligations under WAC's office space lease. Appellant-husband received as a distribution all office furnishings/effects as well as three motor vehicles. (*Id.* at 4.) Appellant-husband was obligated to borrow $239,000 from Breevast U.S., Inc. (a corporation that was a partner with WAC in another partnership) and contribute this to WAC as a capital contribution. (*Id.*) WAC was immediately required to distribute this cash to ARNO either as a loan, or as a reimbursement of prior capital contributions, at ARNO's election. Mr. Borie was then given an

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[7] It is unclear to Board staff whether appellant-husband made any additional contributions.

[8] It appears that any gains would be allocated first to appellant-husband to wipe out any allocated losses.

option to purchase appellant-husband's interest in WAC for $1. Appellant-husband could withhold consent to the option for five years if the cost to appellant-husband was greater than $10,000 in aggregate income taxes. Thereafter, Borie was free to exercise the option. The deficit restoration requirement of WAC partnership agreement was completely deleted. (*Id.* at 3.) After this reorganization, according to the Forms K-1 provided for 1996 through 2001(Appellants' Reply Br., Ex S.), after 1995, appellant-husband did not receive any allocations of income, but continued to show a negative capital account of ($3,257,815).

WAC discontinued business on December 31, 2001 and filed its final partnership return in September 2002.[9] The 2001 California Schedule K-1 issued to appellant-husband from WAC shows a beginning negative capital account of -$3,257,815, and a capital contribution (the Capital Contribution) of the identical amount, resulting in an ending capital account of $0. Appellant-husband signed the final partnership return as a general partner. Respondent contends that appellants signed and filed a California joint return for 2001 on October 15, 2002 reporting negative federal adjusted gross income of -$8,084 and positive California adjusted gross income of $69,212, which after adjustments resulted in zero California income taxes for 2001. (Respondent's Opening Br. at 2.)

In June 2004, respondent contacted WAC to substantiate the 2001 Capital Contribution made by appellant-husband and requested a copy of the WAC partnership agreement. No WAC partnership agreement was produced at audit or protest. On June 2, 2006, respondent notified WAC that there was no evidence that the Capital Contribution was made by appellant-husband. Respondent issued its Notice of Proposed Assessment (NPA) on September 18, 2006, which disallowed the Capital Contribution. According to respondent, once the Capital Contribution was denied, this left appellant-husband with a negative capital account of $3,257,814. Respondent then treated the dissolution of WAC as resulting in a deemed distribution of cash in the amounts of $3,257,814 from WAC that exceeded appellants' basis in the WAC partnership. This Deemed Distribution resulted in additional tax. In

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[9] (Respondent's Opening Br. at 1 and Exhibit A.) Although a final partnership return exists for WAC, at the oral hearing appellants should be prepared to discuss whether the business operations (i.e., the partnerships held by WAC) were dissolved and the assets distributed to the partners or whether WAC's business operations were transferred to a different entity. According to Board staff's November 2009 internet search, a Wattson Arno Company is listed in Newport Beach, California. *See* http://www.directory-of-professionals.com/california-newport-beach-real-estate-agents.html last viewed on Nov. 20, 2009.

addition, respondent imposed the accuracy-related penalty and post-amnesty penalty.

Appellants protested the NPA. At the protest oral hearing, appellants' representatives conceded that appellants' capital account had not been restored in 2001.[10] Based on this finding, respondent affirmed the NPA in its Notice of Action dated March 10, 2008. This timely appeal followed.

<u>Contentions</u>

<u>Appellants' Contentions</u>

Appellants contend that there was no deemed distribution to appellant-husband under Internal Revenue Code (IRC) section 752(b). Appellants read IRC section 752(b) to result in a deemed distribution of cash only if the following conditions exist:

1. WAC had liabilities (which the partner (appellants) were relieved of (hereafter, prong 1)); or
2. Appellants had liabilities which WAC assumed (hereafter, prong 2).

Appellants contend that since neither of those conditions existed in 2001, there can be no deemed distribution to appellants. Appellants claim that respondent initially asserted liability under IRC section 752(b) based on prong 1 above (Appellants' Reply Br. at 5), but now for the first time at appeal is raising prong 2 and should be estopped from asserting it. Appellants believe respondent has abandoned prong 1 because WAC did not have any liabilities in 2001. Appellants explain respondent's approach as follows: if the Capital Contribution was not made, then in order for appellants to restore their capital account to $0 in order for the partnership to liquidate, appellants had to receive a "deemed distribution" from the partnership to do so (the concept of WAC assuming a liability of appellants to restore the capital account to $0, will be referred to hereafter as the Assumption Theory). (*Id.* at 6.) Appellants claim no authoritative support for respondent's Assumption Theory exists. Appellants, citing *Appeal of David G. and Helen Mendelsohn*, 85-SBE-141, Nov. 6, 1985, claim that if a new position is raised by respondent on appeal that either alters the original deficiency or requires the presentation of different evidence, then a new matter has been introduced, and the burden of proving the new position shifts to respondent.

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[10] At the oral hearing, appellants should be prepared to explain why the return shows a $3,257,814 capital contribution to the partnership, when there appears to have been no such contribution. If this is a mistake, appellants should be prepared to explain how/why a mistake of this magnitude occurred.

Appellants believe respondent's Assumption Theory of creating a deemed assumed liability under prong 2, by the need for appellants to "restore" their capital account to zero upon liquidation, is fatally flawed because the two premises upon which this theory rests are legally and factually erroneous. According to appellants these faulty premises are:

1. in order for WAC to liquidate, appellants had to restore their capital accounts; and
2. since appellants did not make a capital contribution to restore their capital accounts, WAC "assumed" their obligation to restore their capital account to zero (i.e., thus triggering a deemed distribution under prong 2.) (*Id.* at 7.)

As for the first premise, appellants contend that they were not obligated to restore their capital account to zero before WAC could liquidate in 2001. Appellants contend that respondent's reliance on California Corporations Code (CC) section 16807, subdivision (b) is misplaced because when a partnership agreement exists, CC section 16103 states that the partnership agreement governs. Appellants state that since the partners elected to govern themselves under the WAC partnership agreement as modified by the reorganization agreement, and the WAC partnership did not include a deficit-make-up obligation, then CC section 16807, subdivision (b) does not apply. Second, appellants contend that even if it did apply, respondent's position that WAC could not legally liquidate without a capital contribution is erroneous. Appellants claim that CC section 16807, subdivision (b) simply states that if a partner has "any excess of the charges over the credits of the partners' account," he shall contribute that amount to the partnership. (*Id.* at 9.) Appellants claim that if a partner fails to make the deficit up, all the other partners shall contribute the additional money to satisfy the partnership obligations for which they are liable under CC section 16306. (*Id.*) Appellants claim that there is no authority for preventing the partnership from liquidating if appellants failed to restore their capital account. Finally, appellants contend that respondent has assumed that the "partner's account" referenced in CC section 16807 is equivalent to a partnership's "capital account" for income tax purposes. Appellants claim that there is no authority for making these terms synonymous.[11]

Appellants claim respondent's second premise, that WAC had to "assume" the liability to

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[11] Board staff presumes appellants are contending here that CC section 16807 may not apply because the term "partner's account" as used in this section may not have anything to do with the term partner's capital account.

restore the capital account, is not supported by any authority and respondent has not cited any.

Appellants state that WAC was in the real estate investment/rental business and that most, if not all, of the projects which WAC and related partnerships invested in were in Southern California and consisted of commercial properties. (Appellants' Reply Br. at 2.) As a consequence of the 1990's recession, by 1996 all of WAC's investments were "under water" in that their liabilities exceeded their values. (*Id.*) Appellants state that as of July 1, 1995, they had a negative net worth in excess of their $3,276,933 share of WAC liabilities. As a result, ARNO was to "take over" the WAC partnership, including its assets and liabilities, pursuant to a reorganization agreement. (*Id.* at 3 and Exhibit C.) Appellants contend that after they made a capital contribution of $239,000 in 1995, they were no longer liable for the partnership debts. (Appellants' Reply Br. at 3-4.) It appears to Board staff that appellants contend that if any tax were triggered for deemed distribution (resulting from the release of partnership liabilities) it would have been due, if at all, in 1995 or 1996. Appellants state that the reduction of appellants' share in the liabilities of WAC was fully disclosed on appellants' Schedule K-1s for 1995 and 1996. (*Id.* at 10 and Exhibit D.)

Appellants claim that respondent cannot rely on the duty of consistency to "fabricate" a partnership liability for 2001 and then seek to tax appellants on a deemed distribution. Appellants also claim that the burden of proof for raising the duty of consistency rule is on respondent. Appellants state that since appellants fully reported their reduction of liabilities in 1995 and 1996, respondent must demonstrate that it detrimentally relied on their earlier K-1 filings. Appellants contend that it was respondent who misapplied IRC section 752(b), not appellants' reporting position. Appellants contend also that WAC's final return was not the only way respondent could have identified an earlier IRC section 752(b) distribution, that this was clearly identifiable from the earlier 1995 and 1996 filings and that the 1999 WAC Form 565 Balance Sheet also identified a complete elimination of WAC's liability. Citing, *Estate of Posner v. U.S.*, T.C. Memo 2004-112, appellants contend that where the taxpayer "adequately disclosed the relevant facts and documents" to respondent prior to the expiration of the statute of limitations in an earlier year, respondent cannot establish detrimental reliance. Appellants contend that respondent through its audit powers could have discovered the deemed distribution occurred back in 1995 or 1996. (*Id.* at 19.) Appellants also claim that just because tax was not paid in

1995 or 1996, that a "mere failure to report income is not a representation that such income has in fact not been received." (*Id.* at 20). Appellants appear to believe that the failure, if any, to report income in 1995/1996 constituted a mutual mistake of law on the part of appellants and respondent and that a mutual mistake of law does not create estoppel for purposes of invoking the duty of consistency.[12] Appellants contend that respondent's mistake of law in 1995 to assert a liability (based on appellants being released from WAC liabilities at that time) precludes respondent from raising the duty of consistency for 2001. (*Melon v. U.S.,* (3rd Cir. 1950) 184 F. 2d 157.)

Appellants also contend that respondent is erroneously attempting to underpin its duty of consistency argument by the following alleged misrepresentations of appellants: (a) the 2001 WAC Form 565 shows that the Capital Contribution was made when it was not; and (b) on the 1995 WAC K-1 issued to appellants, no deemed distribution is reported. As for the first alleged misrepresentation, appellants claim that this alleged misrepresentation cannot provide a basis for estoppel because, [w]hatever impact the inaccuracy that representation may have on the computation of appellants' tax return can be made in 2001 – an open year." (*Id.* at 24.)[13]

Appellants contend that even if respondent prevailed in estoppel (*i.e.,* showing that respondent relied on the K-1s in 1995 and 1996 where debt relief was shown, but no income of $3,276,933 was reported), such income would have been treated as cancellation of debt (COD) and exempt from taxation under the insolvency provisions of IRC section 108(a)(1)(B) – since WAC was insolvent. In other words, appellants' counterargument to respondent's detrimental reliance argument (where respondent is alleging that it cannot now go back and tax the 1995 income) is that respondent could not have imposed tax in 1995 anyway, because the income was exempt COD income. Thus, appellants contend respondent cannot raise the duty of consistency because it cannot show that it relied (to its detriment) on appellants' earlier filing position. (*Id.* at 28.)

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[12] Appellants raise a number of cases to support the proposition that estoppel is defeated by adequate disclosure of relevant facts to the taxing authorities, which appellant's contend occurred in this case, i.e., respondent was notified of the debt reduction on appellants' WAC schedules K-1s for 1995 and 1996 and given a "second shot" in 1999, when WAC filed a "zero liability" balance sheet with its 1999 Form 565." (*Id.* at 25)

[13] It appears to Board staff that appellants are taking the position that the Capital Contribution for 2001 was not necessary, that reporting there was one (in an attempt to zero out the capital account) was an immaterial error, and that even without the Capital Contribution, there would be no tax due for 2001 under IRC section 752(b).

Appellants contend that even if there were a deemed distribution under IRC section 752(b) pursuant to respondent's Assumption Theory, the net gain upon dissolution should be reduced by the tax benefit rule or in the alternative, passive activity loss (PAL) carryovers, since the WAC losses creating the negative capital account did not reduce appellants' taxes in prior tax years. Appellants' tax benefit rule argument position is that a taxpayer is allowed to exclude from income any recovery of an amount deducted in a prior taxable year to the extent that the deduction did not reduce the taxpayer's taxes in the prior year. (*Id.*) Appellants' characterize respondent's IRC section 752(b) Assumption Theory, as follows: appellants were relieved of an alleged deficit in 2001 and that obligation was created by flow through losses from WAC in earlier years; thus those losses flowed through to appellants in earlier tax years and those earlier losses and the alleged deficit in 2001 are integrated. With respect to this position, appellants state:

> Appellants' reporting of those losses is inconsistent with said assumption. Since Appellants did not realize a tax – reduction from much of those losses in the earlier years, the tax benefit rule excludes that amount from their 2001 income…(tax benefit rule excludes from gain in current year carrying costs/expenses in earlier years that did not generate a tax benefit.)[14]

Alternatively, appellants claim that they have PAL carryovers to 2001 (in the amount of $685,971) and respondent only allowed $331,607. Thus, appellants contend that if they are ultimately held liable for additional income in 2001, they should be allowed to utilize an additional $354,364 PAL for 2001.

Appellants claim that the accuracy-related penalty should not be applied, even if a deficiency were found, because appellants relied in good faith on the advice of a qualified accountant to prepare their tax returns.

Finally, appellants claim that the post-amnesty penalty should not be applied because the statutory requirements for this penalty have not been satisfied and there is reasonable cause for appellants not participating in the amnesty program.

<u>Respondent's Contention</u>

Respondent contends that the deficit make-up obligation requires partners to offset any

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[14] (*Id.* at 28) Board staff does not fully understand this quoted argument. It seems to Board staff that if ongoing losses flowed through from WAC to appellants, appellants could have reduced their own personal taxes on a year-by-year basis accordingly (or at least carried forward a net operating loss). Board staff does not understand how this would not have constituted an earlier tax benefit.

deficit in the partner's capital account resulting from allocated losses and distributions and that this requires either a contribution of cash/property or the partner to take the amount into income. (Respondent's Opening Br. at 4.) Respondent claims that it relied on the general provision of CC section 16807 regarding appellants' deficit make-up obligations, because appellants failed to provide a copy of the WAC partnership agreement. In reviewing this agreement when it was provided at appeal, respondent states that there is a clause requiring each partner to restore their deficit capital account upon liquidation of the partnership. (Respondent's Reply Br., at 4, Exhibit A, 5.4).

Respondent also relies on Treasury Regulation section 1.704-1(b)(2)(ii)(b) which requires partnership allocations to have a substantial economic effect. Such allocations can only have a substantial economic effect if the partner restores the deficit balance by the end of such taxable year or within 90 days of liquidation. Respondent contends that appellants assumed a share of WAC liabilities until 1995 in order to increase their basis in WAC. This allowed appellants to take the tax benefit of large deductions. (Respondent's Opening Br. at 5.) Thus, when WAC liquidated and the capital deficit was not restored, this resulted in the prior allocations not having substantial economic effect under Treasury Regulation section 1.704.

Respondent characterizes appellants as arguing that the reorganization agreement "overrides" the WAC partnership agreement, because the reorganization statement absolves appellant-husband from further capital contributions and he does not have a financial obligation to the partnership (Respondent's Exhibit B § 1.) Respondent notes that appellants have not reconciled their reporting of a "false" capital contribution in 2001 with their assertion that they never had to do so anyway after 1995. Respondent contends that even after 1995, appellant-husband chose to continue as a partner in the partnership receiving forms K-1 showing he had a deficit capital account in the partnership. Moreover, respondent contends that prior to 1995, appellants continued to take advantage of deductions in excess of the money they contributed to the partnership. Respondent points out that the reorganization agreement states that appellants could withhold consent for WAC to liquidate, if the dissolution were to cost in excess of $10,000 in income tax to appellants, which was to be in effect for 5 years. (*Id.* Exhibit B, § 1.) Thus, respondent contends that the reorganization agreement appears to have been instituted to avoid income taxation in the event that the WAC partnership liquidated. (*Id.* at 4) Respondent states that although appellants contend they had no obligation to the partnership, by filing forms K-1 showing deficits to respondent, appellants indicated to respondent that they did have such an obligation to the partnership (*i.e.*, to restore the capital account deficit at some point in time) and that the 2001 filing made it appear as though they met that obligation in 2001, when in fact they had not. Respondent also states that since appellants continued to report a capital account deficit after 1995 (with respondent's assumption that losses being taken after 1995 had substantial economic effect, because appellants would eventually make up the deficit), when the partnership liquidated in 2001, appellants should be consistent in their filings and show their partnership allocations had substantial economic effect in the prior years, by making up the deficit in 2001. (*Id.* at 10).

Respondent contends that the duty of consistency applies because respondent relied on appellants' K-1 filings from 1996 through 2001 (showing capital account deficits) and on appellants' personal income tax return in 1995 which did not report any deemed distribution. Respondent contends that it relied on these filings by accepting them and allowing the statute of limitations to expire.

Respondent takes issue with appellants' contention that they had no obligation to restore their capital account. Respondent contends that appellants' position (*i.e.*, that ARNO could restore the deficit) is correct in theory, but ARNO did not do so. (*Id.* at 2.) Respondent contends that the requirement to restore a capital deficit to WAC was a liability of appellants to the partnership. Respondent states that this is the point of CC section 16807. Respondent states that even if the partnership agreement overrides the application of CC section 16807, IRC sections 704 and 752, when taken together mandate that a partner restore his deficit capital account once the partnership liquidates. Respondent claims that this requirement is also found on the IRS's website:

> LIQUIDATION/TERMINATION
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> Care must be taken to ensure that any negative capital account is reported in income in the year of liquidation. Although partners are happy to include liabilities in basis during the operating years in order to deduct losses, they frequently forget to include those liabilities in the amount realized on the disposition of their interest. Since the partner is "deemed" to be relieved of liabilities on the disposition of his partnership interest, even a gift or charitable contribution of a partnership interest will result in a gain where the capital account was negative. Sometimes the final partnership return will show that some partners have negative capital accounts and others are positive- the total of the ending capital accounts being zero. The regulations require that final year income be allocated

> to those with negative capital accounts until they reach zero such that all ending capital accounts are zero.[15]

Thus, respondent contends that upon liquidation, WAC was deemed to be relieved of liabilities when the partnership liquidated.

As for the relieved debt liabilities of 1995, respondent claims that income due in 1995 is a separate issue from the relieved liabilities in 2001. (Respondent's Reply to Add'l Br. at 2). Respondent states that the failure to report COD income on appellants' 1995 return is a separate matter that respondent is not pursuing. (*Id.*) Respondent insists that the deficit capital account was not impacted by the K-1s from 1995 and 1996; it was simply carried forward until 2001 when it was purportedly cancelled by the Capital Contribution (which in fact was not made). (*Id.*)

During the briefing of this appeal, Board staff requested respondent to provide any case law or authority holding that a partner recognizes income when the partnership is liquidated and at that time the partner has a negative capital account. In response, respondent stated that it is relying on CC section 16807, subdivision (b) that requires a deficit make-up obligation and IRC section 752(b) to create a deemed distribution.

As for appellants' COD income argument for 1995/1996, respondent states that this argument was first raised by appellants in their reply brief during this appeal, that COD income would only exist to the extent appellants could show that they (not WAC) were insolvent. Respondent claims that no evidence of appellants' insolvency was provided and that moreover, even if they had been insolvent, they would have had to reduce their tax attributes (i.e., PAL carryovers) to zero under the provisions of IRC section 108(d)(3). (*Id.* at 5.) Respondent also contends that appellants' failure to reduce their tax attributes belies their claim of insolvency.

With respect to appellants' PAL calculation, respondent contends that it relied on appellants' PAL calculation provided on Form 3801 from 1987-2001. (*Id.* at 6, Exhibit E.) Respondent contends that appellants are now claiming this earlier information was incorrect and in addition,

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[15] (Respondent's Reply Br. n.7 and accompanying text; *see also* IRS Partnership - Audit Technique Guide - Overview (Published 12-2002) available online at http://www.irs.gov/businesses/partnerships/article/0,,id=134689,00.html – last visited on Nov. 19, 2009.)

appellants included ordinary losses in their PAL computation which were not a result of passive activities and appear to have already been deducted on appellants' Schedule E. (*Id.*, Exhibit F.) Thus, respondent believes the original Form 3801 PAL filings should be relied on by the Board.

Applicable Law

Fully understanding the detailed contentions by the parties (capital accounts, substantial economic effect, partnership allocations of losses and profits, deemed distributions, etc.) requires an understanding of federal partnership tax rules that can be highly complex.[16] Therefore, the following represents Board staff's understanding of the rules at issue in this appeal, which cites relevant primary law (e.g., federal Treasury Regulations), and provides explanations and examples from secondary resources (e.g., a partnership tax textbook and treatise).[17]

Partnership Allocations and Substantial Economic Effect

Partnerships are not taxable entities; the income/gains and losses are "allocated" to the various partners who report such items on their respective income tax returns. How such items are to be allocated is generally determined by the partnership agreement. (Int. Rev. Code § 704(a).) If there were no rules to regulate the allocation process, abuse could easily follow. For example, a high net worth individual with income from outside the partnership could be allocated all of the partnership losses (this would cancel out her outside income on her personal tax return); another partner in the partnership who has losses from her outside business activities could be allocated all of the gains (this would also cancel out income from the partnership on her personal tax return). Thus, through such allocations, these two partners could reduce their overall tax burdens.[18]

Therefore, in order for an allocation of income/losses from a partnership to be respected for tax purposes, the allocations must generally have substantial economic effect. (Int. Rev. Code

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[16] Some might argue these rules are some of the most complex tax rules within the Internal Revenue Code. California generally conforms to these federal rules under R&TC section 17851.

[17] For the sake of brevity and clarity and to avoid having to repeat some of these rules in the staff comments, where applicable, Board staff may tie some of the applicable legal rules discussed in this section to points/arguments/rules raised by the parties in this appeal.

[18] Board staff believes respondent may be implying that similar manipulation may have occurred with WAC, with appellants' ownership interest being higher in the years for which WAC had losses and lower in the years in which WAC had gains. (Respondent's Opening Br. n.5 and accompanying text.)

§ 704(b).) An allocation will have substantial economic effect if it meets a safe harbor provision of the regulations or it is in accordance with the partner's interest in the partnership. (Treas. Reg. § 1.704-1(b)(3).).

A safe harbor for showing that allocations have substantial economic effect under the regulations requires a two-part showing: first the allocation must have economic effect; and second, the allocation must be substantial.[19] Economic effect can be mechanically shown by inserting within the partnership agreement the following three operating requirements: (a) capital accounts must be maintained by the partners in conformity with the rules contained within the regulations; (b) liquidation distributions must be made in accordance with the positive balances in the partner's capital accounts; and (c) after liquidation, any negative capital accounts must be unconditionally restored by that particular partner (i.e., this last requirement is referred to as the deficit make-up obligation or the deficit restoration obligation). (Treas. Reg. § 1.704-1(b)(2)(ii).)[20] This three-part requirement for economic effect will be referred to as the Basic Test.

Substantial Economic Effect and Partnership Capital Accounts

The goal of the Basic Test is to ensure that income/losses allocated to a partner makes economic sense and is not merely an attempt to manipulate the partners' individual tax liabilities. For example,[21] assume G and L, two general partners, form a general partnership by contributing $50 each. The GL partnership agreement provides for all three requirements of the Basic Test. During the first year, the partnership has a $60 loss, which is specially allocated solely to L under the partnership agreement (a special allocation agreement requiring all losses in the first year to be allocated to L). Note that L received a $60 loss, when she only contributed $50. It would normally not make economic sense

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[19] The Treasury Regulations under IRC section 704(b) for demonstrating substantial economic effect are complicated. Board staff is limiting its applicable law discussion to the portions of the regulations which appear relevant in this appeal. To the extent the parties believe this discussion needs to be extended, they should be prepared to expound on the regulations at the oral hearing.

[20] Board staff notes that because of this safe harbor provision, many partnership agreements automatically include paragraphs with the intent of satisfying the safe harbor requirements (i.e., stating capital accounts will be maintained in accordance with the regulations and providing for some form of limited deficit make-up clause). The WAC original partnership agreement had a deficit make-up obligation clause, which the reorganization agreement later deleted.

[21] The following example is taken from a partnership textbook. Cunningham and Cunningham, *The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships*, 2d Ed. Ch. 5, at 51.)

for G to "allow" this $10 loss beyond L's capital account to go to L. If the partnership liquidated at the end of the first year G's and L's capital accounts would be as follows:

	G	L
Initial Balance	$50	$50
First Year Loss	0	$60
	$50	($10)

Since the partnership lost $60 dollars the first year which was wholly allocated to L, if the partnership liquidated (presumably selling the assets for $40 – i.e., after the $60 loss to the original $100 value of the partnership), economically, G would want her investment of $50 back (not just the $40 proceeds from the liquidation of assets), since L got to "use" the entire $60 loss. The deficit make-up obligation makes G economically whole by requiring L to contribute $10 to the partnership so G can get her $50 back, instead of only the remaining $40 from the proceeds of the sale. If there was no deficit make-up obligation, L would have received a $60 special loss for a $50 contribution. Thus, the deficit make-up obligation is intended to align the tax allocations of income/loss with the underlying economic burdens/benefits between partners.[22]

A book capital account (or partner's equity account, hereafter referred to as the capital account) reflects a partner's economic interest in the partnership. The capital account is increased by the fair market value of any contributions,[23] property (net of liabilities), or income/gain allocated to the partner and are decreased by draws on the capital account, distributions (net of liabilities), or losses/expenditures[24] allocated to the partner. (Treas. Reg. § 1.704-(1)(b)(2)(iv)(d).) Placing the capital account into the basic accounting formula, if Assets = Liabilities + Equity (i.e., A = L + E, referred to hereafter as the accounting formula), then the capital account resides in the Equity portion of the accounting formula. Thus, liabilities of the partnership are not reflected in the capital account (they will affect the A and L portions of the accounting formula). "Therefore, no adjustments are made to capital

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[22] Board staff believes this general rule explains why respondent questions why ARNO allowed appellant-husband to maintain a very high negative capital account over time. One would normally expect ARNO to be concerned about appellant-husband's negative capital account in the same way partner G would be concerned about L's negative capital account in the previous example.

[23] In the previous example, G's and L's capital accounts were increased by their original $50 contributions.

[24] In the previous example, L's $50 capital account was reduced by the $60 loss allocated to her.

accounts when a partnership borrows or repays a loan, and the adjustments to capital accounts for contributed and distributed property are made net of liabilities." (Cunningham and Cunningham, *The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships,* 2d Ed. Ch. 4, at 34; Treas. Reg. § 1.705-1(a).)

Capital Accounts and Outside Basis

Allocations of gains or losses will affect the partner's capital account; however, allocations of gains/losses will also affect another fundamental partnership concept, the partner's outside basis. There is an important distinction between a capital account and a partner's outside basis that warrants emphasis. A partner's outside basis represents her basis in her partnership ownership interest in the partnership. Conceptually, for comparison purposes, if a partnership were a corporation, a partnership interest would be like the stock of a corporation, and outside basis would be the basis of such stock.

The following example (hereafter referred to as the Land Example) underscores the difference between a capital account and outside basis.[25] ((Cunningham and Cunningham, *The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships*, 2d Ed. Ch. 4, at 37-38.) Partners C and L form a 50/50 general partnership, with C contributing $150 in cash and L contributing land he purchased for $100 (which now has a value of $150). C and L are both given full fair market value of these contributions to their capital accounts –Assets ($300, i.e., Land $150 + Cash $150) = Liabilities ($0) + Equity ($150 to C and $150 to L). However, since L's original basis in the land was $100, his basis in his partnership interest (or outside basis) will only be $100. If the land is sold for $150 and the partnership then liquidated, normally, assuming the Basic Test was met, both partners would obtain $150 each in a liquidating distribution.[26]

Establishing Outside Basis and the Effect of Debt on Outside Basis

The outside basis of a partner's ownership interest in a partnership is originally established under IRC section 722 as the partner's basis of property contributed to the partnership (e.g.,

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[25] For reasons that will become clear, the distinction being drawn affects the legal issue between the parties with respect to how IRC section 752(b) should be applied.

[26] As for the $50 taxable gain on the land, partner L would normally be allocated all of it under IRC section 704(c).

$150 for C and $100 for L in the Land Example) and can be increased during the life of the partnership by additional contributions. (Treas. Reg. § 1.705-1(a)(2).) Outside basis is also increased by the partner's share of taxable income/gains and earned exempt income. Outside basis is decreased (but not below zero) by a partner's share of losses and nondeductible expenditures. (Treas. Reg. § 1.705-1(a)(3).) Unlike capital accounts, outside basis can be adjusted for liabilities acquired by the partnership (such as recourse and nonrecourse loans for real estate acquisition purposes).[27] (Treas. Reg. § 1.705-1(a)(6).) It appears that these rules are further explained in IRC section 752. (*Id.*) IRC section 752(a) provides that an increase of a partner's share of liabilities (such as a loan obtained by the partnership to acquire real estate) constitutes a contribution of money by that partner to the partnership. IRC section 752(b) provides that a decrease in a partner's share of liabilities constitutes a distribution of money by the partnership to the partner. Such "deemed" contributions/distributions to/from the partnership will affect the partner's outside basis, but not the partner's capital accounts. The following example highlights the distinction between a capital account and outside basis when debt is involved. If A and B as general partners form a 60/40 partnership with A and B contributing $60 and $40 in cash, respectively. Then, the partnership immediately purchases real estate for $1,000, paying $100 in cash and obtaining a $900 mortgage, the capital accounts would be $60 and $40 for A (60%) and B (40%) (i.e., Asset ($1,000 property) = Liabilities ($900 mortgage: $540 to A and $360 to B) + Equity ($100 (*i.e.*, $60 for A, $40

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[27] Board staff points out that there are also two concepts called the tax asset account and tax capital account. Using the Land Example above, the book value of the cash and land on the asset side of the accounting formula (the asset book account) would be $300 ($150 cash and $150 land). However, the asset tax basis account would be $250 ($150 cash and *$100 for the land.*) This $50 difference is due to the fact that the partnership takes a tax basis in the property contributed by the L partner. This $250 "inside the partnership" basis in its assets is called the partnership's inside basis. C's and L's share of the inside basis of assets contributed into the partnership is tracked on a partner's tax capital account. Thus, C's and L's tax capital accounts in the Land Example would be $150 for C (the basis of cash is its actual value) and $100 for L. Thus, tax capital accounts should equal the asset tax accounts. The reason for tracking the tax basis of assets is because the partnership has to be able to track any taxable gains on property it sells (i.e., it must remember the asset tax basis is $100 on the Land, so when it sells it for $150 it can report $50 of taxable income). The tax capital account is maintained, so the partnership can remember that L is the partner to whom the $50 should be specifically allocated when the land is sold. (*Supra* n.26.) As with book capital accounts, debt liability is not reflected in the tax capital accounts. Thus, in the Land Example, if the partnership borrowed $100, this would increase the book asset account, the tax asset account, and the partners' outside basis by $100, but it would not affect C's and L's tax capital accounts or their book capital accounts. (*See* Cunningham and Cunningham, *The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships*, 2d Ed. Ch. 4, at 38-39 and n.13.) Board staff explained the tax capital account concepts because the parties raised it in their briefs, with respondent contending that the tax capital calculations provided by appellant-husband are incorrect. (Respondent's Opening Br., at 8 and Exhibit D at 7.) Board staff is unsure whether appellant-husband's tax capital accounts are material to the outcome of this appeal. To the extent the parties believe otherwise, they should be prepared to provide such arguments at the oral hearing.

for B)). However, under IRC section 752(a) A's and B's outside basis would be $600 for A ($60 + $540) and $400 for B ($40 + $360).[28] (Cunningham and Cunningham, *The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships*, 2d Ed. Ch. 4, at 110-11.)

Outside Basis and the Interplay of IRC Section 752

A partner's outside basis has substantial consequences for a partner. As stated above, a partner's outside basis cannot go below zero.[29] Under IRC section 704(d), a partner cannot deduct allocated losses below her outside basis. Thus, if a partner's outside basis is zero, losses are suspended.[30]

Perhaps more important than the suspended loss rule of IRC section 704(d) (at least for purposes of this appeal) is the interplay between IRC sections 752 and 731. The general rule of IRC section 731 is that distributions from a partnership do not result in tax to the partner.[31] However, this rule has a very important exception: the portion of the deemed IRC section 752(b) distribution that exceeds the partner's outside basis is taxable. (Int. Rev. Code § 731(a)(1).) Thus, if a partner has an outside basis of zero and is relieved of $1,000 in partnership debt, then the entire $1,000 is treated as a distribution under IRC section 752(b) and is then taxable under IRC section 731(a)(1).[32]

Finally, a "liability" for IRC section 752 purposes is an obligation that (a) creates or increases the basis of any of the obligor's assets (*e.g.*, normal borrowings that will increase a partner's outside basis),[33] (b) gives rise to an immediate deduction to the obligor (e.g., unpaid expenses of an

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[28] Board staff has kept the explanation simple. The regulations go into great detail regarding how recourse and nonrecourse debt should be treated.

[29] Note that a capital account can be negative, as was apparently the case with appellant-husband.

[30] It appears that appellant-husband's losses from WAC may have been suspended, partly as a result of this rule.

[31] This general rule is important to keep in mind in this appeal. For example, assuming appellant-husband actually received a "deemed" distribution from the partnership equaling his negative capital account in 2001, such a distribution would not automatically be taxable under the general rule.

[32] Since IRC section 731(a)(1) treats a deemed distribution under IRC section 752(b) as taxable based on whether it exceeds the partner's outside basis, Board staff questions whether respondent's focus on the negative capital account is misplaced (unless respondent is using appellant-husband's capital account as a proxy for his outside basis). As stated above, outside basis and the capital account are different concepts.

[33] Loans do not increase capital accounts.

accrual basis partnership), and (c) expenses that cannot be deducted or capitalized, such as syndication fees. (Treas. Reg. § 1.752-1(a)(4)).[34]

California Default Partnership Rules

CC section 16103(a) provides that "[t]o the extent the partnership agreement does not otherwise provide, this chapter [Chapter 5, Uniform Partnership Act] governs relations among the partners and between the partners and the partnership."

CC section 16807, subdivision (b) provides that in the winding up of the partnership, "a partner shall contribute to the partnership an amount equal to any excess of the charges over the credits in the partner's account."

The Duty of Consistency

The duty of consistency was discussed by the Ninth Circuit Court of Appeal in 2000 in *Ashman v. Comm'r*:

> While it is true that income taxes are intended to be settled and paid annually each year standing to itself, and that omissions, mistakes and frauds are generally to be rectified as of the year they occurred, this and other courts have recognized that a taxpayer may not, after taking a position in one year to his advantage and after correction for that year is barred, shift to a contrary position touching the same fact or transaction. When such a fact or transaction is projected in its tax consequences into another year there is a duty of consistency on both the taxpayer and the Commissioner with regard to it, whether or not there be present all the technical elements of an estoppel.

(*Ashman v. Comm'r* (9th Cir. 2000) 231 F. 3d 541, 543.) In *Ashman*, the taxpayer received a distribution of $725,502 from a qualified defined benefit pension plan in 1990. On her 1990 return she indicated that all of it had been rolled over to a new plan, when in fact she missed the roll over deadline for $100,502.21 of the distribution, which she deposited into a new plan with Great Northern Insured Annuity Corporation (GNA) in February 1991. "The Commissioner did not review or challenge the roll over, and there matters stood for awhile." (*Id.* at 542.) In 1993, she withdrew substantially all of the deposit with GNA and failed to report it in 1993. Since the statute of limitations had already passed for the failed roll over for 1990, the taxpayer contended that the time for taxing this failed distribution was

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[34] Accordingly, it does not appear that a capital account represents a liability for IRC section 752(b) purposes. Thus, it is questionable that canceling a partner's negative capital account constitutes a decrease in a partner's share of liabilities (or individual liabilities) for IRC section 752(b) purposes.

1990, and that the distribution in 1993 was not taxable. The Ninth Circuit explained the rationale for the duty of consistency as follows:

> The applicable principle is fundamental and unquestioned. "He who prevents a thing from being done may not avail himself of the nonperformance which he has himself occasioned, for the law says to him, in effect: 'This is your own act, and therefore you are not damnified.'" Sometimes the resulting disability has been characterized as an estoppel, sometimes as a waiver. The label counts for little. Enough for present purposes that the disability has its roots in a principle more nearly ultimate than either waiver or estoppel, the principle that no one shall be permitted to found any claim upon his own inequity or take advantage of his own wrong.
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> When all is said and done, we are of the opinion that the duty of consistency not only reflects basic fairness, but also shows a proper regard for the administration of justice and the dignity of the law. The law should not be such a [sic] idiot that it cannot prevent a taxpayer from changing the historical facts from year to year in order to escape a fair share of the burdens of maintaining our government. Our tax system depends upon self assessment and honesty, rather than upon hiding of the pea or forgetful tergiversation.

(*Id.* at 543-44 (citations omitted).)

In *Ashman*, the Ninth Circuit identified the following three elements for meeting the duty of consistency:

> (1) A representation or report by the taxpayer; (2) on which the Commissioner has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner. If this test is met, the Commissioner may act as if the previous representation, on which he relied, continued to be true, even if it is not. The taxpayer is estopped to assert the contrary.

(*Ashman* at 546)

The Accuracy-Related Penalty

California conforms to the federal accuracy-related penalty provisions of IRC sections 6662 and 6664 under R&TC section 19164. IRC section 6662(d) provides that a substantial understatement of income tax occurs if the amount of the understatement exceeds the greater of (i) 10 percent of the correct tax for the year, or (ii) $5,000. If the Board determines an understatement existed and that the $5,000 threshold was exceeded, then the accuracy-related penalty would facially apply.

Even if the Board determines that an understatement resulted in the accuracy-related penalty, this penalty can be waived if the taxpayer has either substantial authority for the position or adequately discloses the position taken on a statement attached to the return and there is a reasonable basis for that position. (Int. Rev. Code § 6662(d)(2)(B).) The penalty can also be waived if the taxpayer meets the reasonable cause and good faith exceptions under Treasury Regulation section 1.6664-4(a). This reasonable cause and good faith exception may apply if a taxpayer relied on professional tax advice and that advice is based upon all of the pertinent facts and circumstances and the law as it relates to those facts.

Post-Amnesty Penalty

In 2004, the Legislature enacted the income tax amnesty program. (Rev. & Tax. Code, §§ 19730-19738.) Eligible taxpayers could participate by filing an amnesty application and paying their outstanding liabilities of tax and interest, or entering into an installment plan, during the period of February 1, 2005, through March 31, 2005, inclusive. (Rev. & Tax. Code, §§ 19730 & 19731.) For liabilities that remained outstanding after the last day of the amnesty period, a post-amnesty penalty was imposed equal to 50 percent of the accrued interest payable. (Rev. & Tax. Code, § 19777.5, subd. (a).) This Board's jurisdiction to review the post-amnesty penalty is extremely limited. For example, a taxpayer has no right to an administrative protest or appeal of an unpaid post-amnesty penalty. (*Id.*, subd. (d).) A taxpayer also has no right to file an administrative claim for refund of a paid post-amnesty penalty, except upon the basis that the penalty was not properly computed. (*Id.*, subd. (e).) Therefore, this Board's jurisdiction to review the amnesty penalty is limited to situations where the penalty is assessed and paid, the taxpayer files a timely appeal from a denial of a refund claim, and the taxpayer attempts to show a computational error in the penalty calculation.

<u>STAFF COMMENTS</u>

Deficit Make-Up Obligation of the WAC Partnership Agreement

It appears to Board staff that appellants did not provide a copy of the WAC agreement and the reorganization agreement until this appeal—more than four years after the audit started. This left respondent relying on the default rules of California's Uniform Partnership Act cited above. Once provided, the reorganization agreement appears to have specifically deleted the original WAC agreement's deficit make-up provision. Thus, since there was a partnership agreement on point, it would appear that California's default deficit make-up obligation of CC section 16807, subdivision (b) would no longer apply pursuant to CC section 16103. Accordingly, at the oral hearing, respondent should be prepared to discuss how CC section 16807, subdivision (b) overrides a partnership agreement's provision that specifically excludes the deficit make-up provision.

Negative Capital Accounts and IRC Section 752(a)

It is unclear to Board staff whether a negative capital account can be defined as a debt for California purposes (i.e., under California debt law, not California tax law.) Thus, it is unclear whether respondent can contend in 2001 whether the cancellation of appellants' negative capital account by the unraveling of appellant-husband's erroneously reported Capital Contribution constitutes a cancellation of debt. From the rules discussed above, under the IRC section 704 regulations, capital accounts are not affected by debt. A negative capital account also does not appear to be a liability for IRC section 752(b) purposes. (*See supra* n.34 and accompanying text.) Thus, it would seem that for partnership taxation purposes, a negative capital account would not represent a liability of the partnership; moreover, a capital account never enters into the liability portion of the account formula in the first place (i.e., a negative capital account would reside in the equity section, not the liability section of the accounting formula Assets = Liability + Equity). Thus, at the oral hearing, if respondent still maintains that a negative capital account constitutes a debt (outside of partnership tax law, i.e., under California general debt purposes), respondent should be prepared to present authority for this proposition. Assuming the "cancellation" of appellant-husband's negative capital account did constitute debt cancellation for California debt purposes, respondent should be prepared to explain who was the debt holder (ARNO or the WAC partnership itself) and when the cancellation of debt actually occurred (e.g., in 2001 or in the closed years of 1995 or 1996).

Similarly, respondent should be prepared to explain how a negative capital account can even enter into the liability purview of IRC section 752(b) and result in tax under partnership tax law. Even if one assumed (1) that a forgiveness of a negative capital account to a partner constituted a "liability"; (2) that this "liability" was "forgiven" upon the liquidation of WAC; (3) and that this debt relief was a deemed distribution under IRC section 752(b), as a "distribution" it would not result in zeroing out a negative capital account; it would actually drive a negative capital account further into negative territory. In addition, such a distribution would only be taxable under IRC section 731 to the extent it exceeded appellants' outside basis. Thus, under IRC section 731(a)(1) it appears to Board staff that the question of whether a deemed distribution under IRC section 752 is taxable requires a look at appellant-husband's outside basis, not his capital account (regardless of whether the capital account is negative or positive).

In an attempt to make sense out of respondent's approach toward appellants in this case, Board staff understands respondent's questioning of appellant-husband's partnership activities and the partnership reporting in that: (1) appellants made a reporting "mistake" in 2001 by reporting a partnership contribution of over $3.2 million, when they in fact did not make such a contribution;[35] (2) appellants apparently did not present the WAC partnership agreement until this appeal and then provided a separate reorganization agreement that repudiated the deficit make-up obligation requirement of appellant-husband (presumably after substantial losses has been allocated to appellant-husband in earlier tax years);[36] (3) from 1997 onward, appellant-husband appears to have merely carried forward the negative capital account, taking no allocations of gains or losses from WAC; and (4) Mr. Borie (the apparent owner of ARNO) was given a $1 dollar option to purchase appellant-husband's interest in the partnership. These facts raise questions about the business activities of the WAC partnership and appellant-husband's role in WAC. Accordingly, at the oral hearing the parties should be prepared to discuss following:

1. Explain the economics of the arrangement of appellant-husband with the WAC partnership, so that the Board can better understand what appellant-husband brought economically to the partnership and what the partnership economically brought to appellant-husband. For example, what expertise as a Managing Partner did appellant-husband have, why did he agree to the reorganization agreement, what drove his capital account so far in the negative (e.g., was it allocated tax losses (depreciation) or possible revaluations of the property for partnership accounting purposes, etc.), and why did ARNO agree to "absorb" the economic burden/loss by not requiring appellant-husband to make up the deficit in his capital account?
2. Appellants should clarify appellant-husband's outside basis in the WAC partnership from 1995

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[35] Board staff submits this would be a red flag in any audit.

[36] The repudiation of the deficit make-up obligation calls into question whether prior allocations of losses from WAC to appellant-husband had substantial economic effect under IRC section 704(b) and the regulations promulgated thereunder.

through 2001, to demonstrate when, if any, IRC section 752(b) deemed distributions may have occurred due to debt relief.

3. Similarly, since appellants appear to contend that debt relief occurred prior to 2001, they should be prepared to explain how appellant-husband, as a general partner with zero capital interest in WAC (and maybe limited capital contributions), became liable for any historic debt and how such debt was forgiven by any outside debt holders. For example, appellant-husband's K-1 for 1994 shows that he is a general partner with a share of $14,087,438 in "other" liabilities. In 1995, his share of liabilities was reduced to $3,276,933, and for 1996, his share of liabilities was reduced to zero (per the K-1s for those years). (*See* Appellants' Reply Br. Exhibit S). Therefore, if appellants contend debt relief occurred prior to 2001, they should be prepared to provide the dates for debt relief and show whether any such debt relief resulted in any gain under IRC section 731.

4. In light of the facts below, could the reorganization agreement be construed in substance to be a sale of appellant-husband's partnership interest to ARNO, with ARNO agreeing to allow appellant-husband to avoid having to make up the deficit in his capital account?

    a. ARNO's owner was given a $1 option to purchase the partnership interest (presumably, if the interest ever did obtain any economic value greater than $1, this option would have been exercised.)

    b. Appellant-husband had 0 percent interest in the capital, profits and loss of WAC post 1996.

    c. Pursuant to the reorganization agreement, appellant-husband appears to have received a liquidating distribution of the office equipment and vehicles used in the partnership? How could the partnership function as an active business operation if it apparently distributed such assets to appellant-husband?

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5. Assuming the partnership with appellant-husband effectively terminated in 1996,[37] why did the partners "continue" partnership reporting into 2001 (showing a negative capital account for appellant-husband)? Does this mean economically, that appellants' "real" capital account back in 1996 should have gone back to zero, because appellants' economic interest in the partnership was effectively eliminated (it appears that he would receive nothing upon liquidation since he no longer retained any profit, loss or capital interests in the partnership)?

Finally, even if respondent is precluded from asserting taxes back in 1995/1996 due to the statute of limitations and from asserting tax in 2001, the parties should be prepared to discuss whether the failure to require appellant-husband to restore his deficit capital account means that respondent is conceding that the losses allocated to him under the original partnership agreement failed to have substantial economic effect. Board staff submits that if appellant-husband's deficit make-up obligation was not adhered to during the life of the entire partnership, an argument exists that allocations made to him (or to ARNO) would not have substantial economic effect. (*See* Treas. Reg. § 1.704-1(b)(2)(ii)(b).) Respondent has raised this argument in tandem with the duty of consistency to support its Assumption Theory). Assuming the Board concludes that the allocations did not have substantial economic effect (a factual finding that can be made within the context of this appeal), respondent would then be permitted to review appellants' open tax years to disallow any loss carryforwards attributable to the WAC partnership.

Accuracy-Related Penalty

If the Board concludes that an understatement greater than $5,000 exists, in order to abate the penalty, appellants should be prepared to show that reasonable cause existed pursuant to the reasonable cause abatement provisions discussed above. For example, it will need to be shown that the tax preparer understood all of the facts and that appellants acted in good faith (including whether the tax

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[37] This assumption is based on the position that a partner's deficit capital account generally represents the amount that the partner would be liable to pay to the partnership's creditors or to the other partners in satisfaction of their positive capital accounts if the partnership sold all its assets at their book value and liquidated. (*See* McKee, Nelson and Whitmire, *Federal Taxation of Partnerships and Partners*, Vol. 1, 2 ed., para. 6.05, last sentence.) If after 1996 appellant-husband had no profit, loss or capital interests in the partnership, would receive nothing upon liquidation and did not have to pay any creditors, it is a fair question to ask whether appellant-husband continued to be a partner after 1996, and if not, then whether this caused the WAC partnership between ARNO and appellant-husband to terminate.

preparer understood that no capital contribution was actually made in 2001.)

Post-Amnesty Penalty

Appellants should be prepared to demonstrate how the Board has jurisdiction over the post-amnesty penalty within the context of this appeal, since the penalty has not yet been paid by appellants.

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