Frazell v. Commissioner, 88 T. C. 1405 (1987)

A partnership for federal tax purposes is formed when parties join with the present intent to conduct a business enterprise, even if not yet formally organized under state law.

Summary

In Frazell v. Commissioner, the Tax Court determined that Audio Cassette Teaching Fund (ACTF) was a partnership for federal tax purposes in 1982, despite not being formally organized as a California limited partnership until 1983. The court found that by December 1982, ACTF had fully subscribed, acquired its business assets, and begun operations, thus triggering the applicability of the partnership audit and litigation procedures under IRC section 6221 et seq. The court invalidated the IRS's notice of deficiency against the Frazells, who were limited partners, because it did not follow the required partnership procedures, leading to the dismissal of the IRS's motion to dismiss for lack of jurisdiction and granting the taxpayers' cross-motion.

Facts

The Frazells invested in Audio Cassette Teaching Fund (ACTF), a partnership formed to lease audio cassette tapes. By December 1982, ACTF had received full subscriptions for all 56 offered units, and the general partner, Richard P. Bryant, had deposited the funds into ACTF's bank account. Bryant also entered into lease agreements for the master tapes and prepaid the rent. ACTF filed a 1982 partnership return, stating it commenced business on November 30, 1982. However, ACTF did not comply with California's statutory recording requirements until April 7, 1983.

Procedural History

The IRS issued a notice of deficiency to the Frazells for their 1982 tax year, which they did not receive. They filed a petition with the Tax Court after receiving a Statement of Tax Due, but it was filed out of time. The IRS moved to dismiss for lack of jurisdiction due to the untimely filing. The Frazells cross-moved to dismiss, arguing the notice of deficiency was invalid because the IRS did not follow the partnership audit and litigation procedures under IRC section 6221 et seq.

Issue(s)

1. Whether ACTF was a partnership for federal tax purposes in December 1982, triggering the application of the partnership audit and litigation procedures under IRC section 6221 et seq.

Holding

1. Yes, because by December 1982, ACTF had fully subscribed, acquired its business

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assets, and begun operations, thus forming a partnership for federal tax purposes despite not being formally organized under California law until 1983.

Court’s Reasoning

The court applied the federal tax definition of a partnership under IRC sections 761(a) and 7701(a)(2), which does not require formal organization under state law. The court found that by December 1982, ACTF had all the elements of a partnership: it was fully subscribed, had acquired its business assets, and had begun operations. The court distinguished this from Sparks v. Commissioner, where the partnership did not vest until the offering closed. The court also noted that even if ACTF’s business activities had not begun, the partnership return filed for 1982 would still trigger the application of the partnership procedures under IRC section 6233(a). The court rejected the IRS’s argument that ACTF was not a partnership until it complied with California’s recording requirements, as state law is not determinative for federal tax purposes.

Practical Implications

This decision clarifies that for federal tax purposes, a partnership can exist before it is formally organized under state law if the parties have the present intent to conduct a business enterprise. Tax practitioners should advise clients that the IRS must follow the partnership audit and litigation procedures under IRC section 6221 et seq. for partnerships formed after September 3, 1982, even if not yet formally organized. This case has been cited in subsequent cases to determine when a partnership exists for federal tax purposes, such as in Torres v. Commissioner and L&B Land Lease v. Commissioner.

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