Harrell v. Commissioner, 91 T. C. 242 (1988)

A partnership qualifies as a small partnership under the TEFRA rules if each partner's share of each reported partnership item is the same as their share of every other reported item.

Summary

In Harrell v. Commissioner, the U. S. Tax Court ruled that the determination of whether a partnership qualifies as a 'small partnership' under the Tax Equity and Fiscal Responsibility Act (TEFRA) should be based on the partnership's reported items on its tax return and Schedules K-1, rather than the potential allocations allowed by the partnership agreement. The case involved a partnership with fewer than 10 partners, where all items were allocated according to capital contributions. The court denied the petitioners' motion to dismiss for lack of jurisdiction, holding that the partnership met the small partnership criteria because it reported no special allocations for the year in question.

Facts

Robert L. Harrell was a general partner in HSCC Investor Limited Partnership No. 102, which had fewer than 10 partners. The partnership agreement allowed for items to be distributed either in proportion to the partners' capital contributions or in accordance with their partnership interests. For the tax year 1983, the partnership reported a net loss and an investment credit, with all items allocated based on capital contributions, as evidenced by the partnership return and Schedules K-1.

Procedural History

The Commissioner issued a statutory notice of deficiency to the Harrells, determining their distributive share of partnership loss and investment credit to be zero. The Harrells moved to dismiss for lack of jurisdiction, arguing that the Commissioner should have issued a notice of final partnership administrative adjustment (FPAA) under the TEFRA partnership audit rules. The Tax Court denied the motion, finding that the partnership qualified as a small partnership and thus was not subject to the TEFRA audit procedures.

Issue(s)

1. Whether the determination of a partnership's status as a 'small partnership' under section 6231(a)(1)(B) should be based on the partnership's tax return and Schedules K-1, or on the potential allocations allowed by the partnership agreement.

Holding

1. Yes, because the court found that the determination should be based on the

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partnership’s reported items rather than the partnership agreement’s potential allocations.

Court’s Reasoning

The court reasoned that for the purpose of determining small partnership status, the focus should be on the partnership’s actual reported items rather than what might be possible under the partnership agreement. The court cited the need for simplicity in applying TEFRA’s audit procedures, stating, “the determination of whether a partnership is a small partnership. . . should be made by examining the partnership return and the corresponding Schedules K-1. ” This approach was deemed consistent with the legislative intent to simplify audits by allowing a straightforward determination based on reported data. The court also noted that the partnership agreement in this case was consistent with the reported allocations, reinforcing the decision to base the determination on reported items. A dissenting opinion argued for a focus on the partnership agreement itself, highlighting potential complexities and misalignments with reported items.

Practical Implications

This decision clarifies that for partnerships seeking to qualify as small partnerships under TEFRA, the reported allocations on the partnership return and Schedules K-1 are crucial. It simplifies the process for the IRS in determining audit procedures, as they can rely on the partnership’s tax filings rather than delving into the complexities of partnership agreements. Practitioners should ensure that partnership returns accurately reflect the intended allocations to avoid unintended consequences in audits. The ruling also implies that partnerships must carefully manage their reporting to maintain small partnership status, as any discrepancies between the agreement and reported items could affect their audit treatment. Subsequent cases have generally followed this approach, reinforcing the importance of accurate reporting in partnership tax filings.

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