Domulewicz v. Commissioner, 129 T. C. 11 (2007)

In Domulewicz v. Commissioner, the U. S. Tax Court held that deficiency procedures apply to passthrough losses from a partnership involved in a Son-of-BOSS tax shelter, but not to the related accuracy-related penalties. The case involved Michael and Mary Ann Domulewicz, who attempted to offset a capital gain with a loss from a complex transaction involving a partnership and an S corporation. The ruling clarifies the jurisdiction of the Tax Court over computational adjustments and affected items under the TEFRA unified audit procedures, impacting how tax shelters and passthrough entities are audited and litigated.

Parties

Michael V. Domulewicz and Mary Ann Domulewicz were the petitioners throughout the litigation, while the Commissioner of Internal Revenue was the respondent.

Facts

Michael Domulewicz, a 20% shareholder in CTA Acoustics, sold his shares in 1999, realizing a $5,831,772 capital gain. To offset this gain, Domulewicz engaged in a Son-of-BOSS transaction, involving a partnership, DMD Investment Partners (DIP), and an S corporation, DMD Investments, Inc. (DII). He contributed proceeds from a short sale of U. S. Treasury notes and the related obligation to DIP, which was not treated as a liability under section 752. DIP then dissolved, distributing its assets, including stock in Integral Vision, Inc. (INVI), to DII, which sold the INVI stock and claimed a $29,306,024 loss. Domulewicz reported his share of this loss on his 1999 tax return, offsetting his CTA gain.

Procedural History

The IRS issued a Final Partnership Administrative Adjustment (FPAA) to DIP, determining that the basis of the distributed stock was zero and that accuracy-related penalties applied under section 6662. No petition was filed challenging the FPAA, leading to the assessment of taxes and penalties related to DIP's adjustments. Subsequently, the IRS issued an affected items notice of deficiency to Domulewicz, disallowing the passthrough loss and assessing penalties. Domulewicz petitioned the Tax Court to dismiss the case for lack of jurisdiction over both the loss disallowance and the penalties.

Issue(s)

1. Whether section 6230(a)(2)(A)(i) makes the deficiency procedures applicable to the Commissioner's disallowance of the petitioners' passthrough loss from DII?
2. Whether the Commissioner's determination of accuracy-related penalties is subject to the deficiency procedures?

Rule(s) of Law

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1. Under section 6230(a)(2)(A)(i), deficiency procedures apply to any deficiency attributable to affected items that require partner-level determinations.
2. The Taxpayer Relief Act of 1997 amended section 6230(a)(2)(A)(i) to exclude penalties, additions to tax, and additional amounts related to partnership item adjustments from deficiency procedures.

Holding

1. The deficiency procedures were applicable to the disallowance of the passthrough loss from DII because it required partner-level factual determinations.
2. The determination of accuracy-related penalties was not subject to the deficiency procedures due to the amendment by the Taxpayer Relief Act of 1997.

Reasoning

The Court reasoned that the passthrough loss from DII required partner-level determinations regarding the stock's identity, the portion sold, holding period, and character of the gain or loss. These determinations necessitated the application of deficiency procedures under section 6230(a)(2)(A)(i). The Court rejected the petitioners' argument that the IRS could assess the tax without deficiency procedures, citing the need for partner-level factual findings.

Regarding the penalties, the Court followed the plain reading of section 6230(a)(2)(A)(i) as amended, which excludes penalties from deficiency procedures. This was supported by legislative history indicating an intent to reduce administrative burden and increase efficiency by determining penalties at the partnership level. The Court acknowledged the potential for assessing penalties before adjudicating related deficiencies but adhered to the statute's clear language, leaving any legislative correction to Congress.

The Court also considered the broader implications of TEFRA's unified audit procedures, designed to streamline audits and ensure consistent treatment among partners. The ruling underscores the distinction between partnership items, which are determined at the partnership level, and affected items, which may require partner-level determinations before assessment.

Disposition

The Tax Court granted the petitioners' motion to dismiss for lack of jurisdiction as to the accuracy-related penalties but denied the motion in all other respects, affirming its jurisdiction over the deficiency related to the passthrough loss.

Significance/Impact

The Domulewicz decision is significant for clarifying the application of deficiency procedures in TEFRA partnership proceedings, particularly in the context of complex tax shelters like Son-of-BOSS. It establishes that while deficiency

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procedures apply to affected items requiring partner-level determinations, penalties related to partnership item adjustments are excluded from these procedures. This ruling impacts how the IRS and taxpayers navigate the audit and litigation process for partnerships and passthrough entities, potentially influencing the design and defense of tax shelter strategies. Subsequent cases and IRS guidance have referenced Domulewicz in interpreting the scope of TEFRA and the assessment of penalties.

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