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MEMORANDUM FOR ASSOCIATE AREA COUNSEL (FINANCIAL SERVICES & HEALTHCARE), LMSB AREA 1, BROOKLYN

FROM: Lawrence Schattner, Chief, Branch 3
(Collection, Bankruptcy & Summonses)

SUBJECT: Application of I.R.C. § 7602(c) to Limited Liability Companies - Definition of “person other than the taxpayer”

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LEGEND:

Company X =
Company Y =
Company Z =
Member 1 =
Member 2 =

Member 3 =
Member 4 =
Member 5 =
Date 1 =
Date 2 =
Year 1 =
Year 6 =
Year 8 =

ISSUE

Whether Company Z should be treated as a “person other than the taxpayer” for purposes of the advance notification requirements of I.R.C. § 7602(c)(1).

CONCLUSION

Company Z should not be treated as a “person other than the taxpayer” for purposes of the advance notification requirements of I.R.C. § 7602(c)(1).

FACTS

During the course of the examination of the consolidated returns filed by Company Y, the examiners discovered a lease stripping transaction involving airplanes owned by Company Z, a subsidiary of Company Y and a member of its consolidated group. As part of an investment structuring plan, Company Z contributed fully-depreciated leased airplanes to Member 1, a corporation that is 100% owned by Company Z and also a member of the consolidated group. On Date 1, an LLC now known as Company X was formed by Member 1 and two other corporations that are owned by Company Z, Member 2 and Member 3.

Shortly thereafter, the composition of the LLC was changed by withdrawal of Member 3 and the addition of two new members. The two new members were Member 4 and Member 5. Consequently, at this stage of the transaction, the aircraft were being held by an LLC which was made up of four members. Two of the members of Company X, Member 1 and Member 2, are owned by Company Z and are members of the Company Y consolidated group.

Pursuant to the terms of Company X’s operating agreement, none of its members were to have any say in the management or control of the company or to be able to act for or bind the company. Instead, management of Company X was vested in a group of three managers who were elected by Company X’s Class B members. The Class A members, Members 4 and 5, had no voting power or voting rights, but did have the power to cause Company X to be liquidated if it failed to make distributions of certain amounts in the years Year 1 through Year 8.

The Company X operating agreement also provided that capital accounts would be maintained for Members 1, 2, 4 and 5. Members 4 and 5 are also referred to as the “equity investors”. Pursuant to the agreement, the capital accounts were to be increased for property contributed by each member and the book income allocated to the member, and decreased for distributions to each member and book losses allocated to each member. On liquidation, the equity investors were to receive cash payments equal to the values of their capital accounts plus “equity investor guaranteed payments.”

Company X filed U.S. Partnership returns for Year 1 through Year 6 in which it designated Member 1 as its tax matters partner. As noted earlier, Member 1 is the entity to which the airplanes were contributed, is 100% owned by Company Z, and is a member of the consolidated group.

On Date 2, Members 4 and 5 sold their interests in Company X to two corporations that are subsidiaries of Company Z. Consequently, after the sale, all of the members of Company X are subsidiaries of Company Z. Because the transaction allocated income from the leased airplanes to a party other than the party that claimed the depreciation relating to them (Company Z’s Transportation & Industrial unit), the transaction is a lease stripping transaction.

In connection with the examination of the returns of Company X, the LMSB Examination team proposes to summons information from Company Z. Company Z has been controlling the examination of Company X and the Tax Director of Company Z has been the team’s point of contact throughout the Company X examination. The Examination team has had no contact with Company X through officers of Member 1 or the managers of Company X.

LAW AND ANALYSIS

Under I.R.C. § 7602(c)(1), an officer or employee of the Service may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of such taxpayer without providing reasonable notice in advance to the taxpayer. The statute also requires the Service to provide the taxpayer with a record of persons contacted both periodically and upon the taxpayer’s request. I.R.C. § 7602(c)(2). The congressional intent behind these requirements is to provide taxpayers with (1) the opportunity to come forward with information before third parties are contacted, and (2) the means to address any business or reputational concerns arising from such contacts, without impeding the ability of the Service to make those contacts that are necessary to enforce the internal revenue laws. With this intent in mind, an interpretative approach to section 7602(c) has been adopted that balances taxpayers’ business and reputational interests, with third parties’ privacy interests, and the Service’s responsibility to administer the internal revenue laws effectively.

For purposes of complying with the advance notice and recordkeeping requirements of the statute, a Service employee must determine whether a person "other than the taxpayer" will be contacted "with respect to the determination or collection of the tax liability of such taxpayer." Accordingly, in order to determine whether the notice and recordkeeping requirements of the statute apply in a given situation, a Service employee must determine who is the taxpayer with respect to whose tax liability a contact is being made.

As stated in the FACTS section of this memorandum, in the instant case the Service is considering issuing a summons in connection with its examination of the returns of Company X, an LLC. Since Company X elected to be classified as a partnership for federal income tax purposes, at least for taxable years ending on or before August 5, 1997, Company X is subject to the TEFRA partnership provisions. [1] The audit of TEFRA partnerships is conducted at the partnership (entity) level pursuant to I.R.C. §§ 6221 through 6234, but any resulting liability is ultimately assessed against the individual partners. The tax matters partner (TMP) is responsible for certain administrative duties during the course of the examination, including keeping the other partners informed to the extent and in the manner provided by regulations. See I.R.C. § 6223(g). Additionally, under section 6223(a), each partner whose name and address is furnished to the Service is entitled to receive notice of (1) the beginning of an administrative procedure at the partnership level with respect to a partnership item, and (2) the final partnership administrative adjustment from any such proceeding.

In a TEFRA partnership proceeding, the tax treatment of partnership items is at issue. Although the respective tax liabilities of the partners may be affected by the results of the partnership-level proceeding, and thus, they are parties to the proceeding, a third party contact relating to the tax treatment of partnership items is not with respect to the determination of the specific tax liability of any of the partners. Hence, the partnership should generally be viewed as the taxpayer for purposes of giving notice under section 7602(c)(1). Notice should be given to the TMP because the TMP is the statutory representative of the partnership and the partners.

Applying the above to the facts in the instant case, the LLC, Company X, should be treated as the taxpayer for purposes of section 7602(c), and the required notices should be provided to Member 1 as the designated TMP of Company X.

[1] As part of the Taxpayer Relief Act of 1997, certain changes were made to the TEFRA partnership provisions, such as the expansion of the small partnership exception, which potentially could effect whether Company X remains subject to those provisions for taxable years ending after the effective date for those changes, August 5, 1997.

A related question is whether contacts with members of an LLC are section 7602(c) contacts. Notwithstanding that we have concluded that the partnership (LLC), rather than the partners (members), should generally be viewed as the taxpayer for purposes of giving notice under section 7602(c)(1), it does not necessarily follow that the partners (members) are persons other than the taxpayer. In fact, for the reasons discussed below, we have concluded that they are not.

Proposed regulations regarding section 7602(c) were issued by the Service on January 2, 2001. In defining the phrase "person other than the taxpayer," the proposed regulations exclude "[a] current employee, officer, or fiduciary of a taxpayer when acting within the scope of his or her employment relationship with the taxpayer." The rationale for this position is explained in the preamble to the proposed regulations as follows:

> The meaning of "person other than the taxpayer" when contacting business entities.
>
> Section 7602(c) applies to contacts with "any person other than the taxpayer." The "person" contacted may be a business entity rather than an individual. IRS employees must often contact employees of business entities. These contacts arise in two situations. First, IRS employees examining a business taxpayer generally must communicate with employees of the taxpayer. Second, in the course of determining or collecting any taxpayer's liability, an IRS employee may need to contact employees of a third-party business entity. For example, when an IRS employee contacts a bank or other business, the IRS employee actually communicates with an employee of the bank or business.
>
> With respect to the first situation, when an IRS employee contacts an employee of a taxpayer under examination, the proposed regulations provide that a taxpayer's employee is not a "person other than the taxpayer" when acting within the scope of his or her employment. Several rationales underlie this position. First, corporations may speak and act only through individuals. Moreover, state law generally provides that employers are responsible for their employees, regardless of the form under which the employer does business, when the employees are acting within the scope of their employment. It seems reasonable, therefore, to treat employees who are acting within the scope of their employment as being part of the business taxpayer under examination. Second, this approach is consistent with how employees are treated elsewhere in the Internal Revenue Code. See I.R.C. 7609(c)(2)(A)(summons issued to any person who is the taxpayer under investigation "or any officer or employee of such person" not considered a summons issued to a third party). From an administrative standpoint, IRS employees examining a business generally rely on certain individuals designated by the taxpayer to provide information and direct the IRS to whichever employees can best provide that information. The

> regulations will not affect this current examination practice and business taxpayers will continue to be informed about contacts with their employees pursuant to current procedures.

Prop. Treas. Reg. § 301.7602-2, 66 Fed. Reg. 77 (Jan. 2, 2001).

Consistent with the above rationale, contacts made with the partners of a TEFRA partnership are not treated as contacts with persons other than the taxpayer. Since a partnership is not a natural person, it can only speak or act through authorized agents or representatives. Similarly, contacts with a partnership generally must be through a natural person, i.e., an individual. By virtue of their owning a partnership interest, the partners are afforded certain rights and charged with certain responsibilities relating to the partnership by state laws such as the Uniform Partnership Act and the Uniform Limited Partnership Act, as well as under the partnership agreement that they entered into with respect to the specific partnership of which they are a partner. In addition, in TEFRA partnerships, each partner has the right to participate in any administrative proceeding relating to the determination of the proper tax treatment of partnership items at the partnership level. I.R.C. § 6224(a). Hence, the partners may be viewed as being in privity with the partnership, at least for purposes of the administrative tax proceeding. Consequently, a contact made with any partner of a TEFRA partnership should be treated as a contact of the partnership, rather than as a third party contact.

Likewise, applying the same rationale and noting that under the Uniform Limited Liability Company Act, members of an LLC generally have rights and obligations comparable to those of partners in a partnership, a contact with a member of an LLC that is subject to the TEFRA partnership provisions should be treated as a contact of the LLC, rather than as a third party contact. Consequently, if, for example, the Service contacted Member 1 or Member 2, the contact would be treated as tantamount to contacting Company X, and thus, would not be a third party contact. The analysis does not stop here, however, because in the instant case, the Service is contemplating contacting Company Z, which is the parent of Member 1 and Member 2, but is not itself a direct member of Company X.

In determining whether contacting Company Z would constitute a section 7602(c) contact, we once again look to the TEFRA partnership provisions for guidance. Under section 6231(a)(2), the term “partner” means not only a partner in the partnership, but also includes any other person whose income tax liability is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership. I.R.C. § 6231(a)(2)(B). In the instant case, Company Z, Member 1 and Member 2, are all members of a consolidated group, the common parent of which is Company Y. Pursuant to Treas. Reg. § 1.1502-6(a), the common parent and each subsidiary that was a member of a consolidated group during any part of the consolidated return year is severally liable for the tax for that year. Thus, by virtue of being a member of a consolidated group that also includes Member 1 and Member 2, the tax liability of Company Z is determined in part by taking into account indirectly partnership items of Company X, the LLC. Therefore, Company Z is treated as a partner (member) of the partnership (LLC) for purposes of the TEFRA partnership provisions. Accordingly, since we determined above that contacting a member is treated as the equivalent of contacting the LLC rather than contacting a third party, contacting Company Z would not be a section 7602(c) contact.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

If you have any questions concerning this matter, please call (202) 622-3630.