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DEPARTMENT OF THE TREASURY  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR  
SPECIAL LITIGATION ASSISTANT

FROM: Deborah A. Butler  
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Tax Shelters – Registration Requirement

This Field Service Advice responds to your memorandum dated October 14, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

- Taxpayer =
- A =
- State X =
- Year 1 =
- Year 7 =
- Livestock =
- Date 1 =
- \$x =
- Date 2 =
- Date 3 =
- \$y =
- Date 4 =
- Date 5 =
- \$z =
- Date 6 =
- Date 7 =

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Year 6 =

### ISSUES

1. Is Taxpayer a farm syndicate within the meaning of I.R.C. § 464(c)(1)(A) and therefore a tax shelter for purposes of section 448 such that it cannot use the cash receipts and disbursements method of accounting.
2. Is A, a partnership spun-off from Taxpayer, a farm syndicate within the meaning of section 464(c)(1)(A) and therefore a tax shelter for purposes of section 448 such that it cannot use the cash receipts and disbursements method of accounting.

### CONCLUSIONS

1. Because Taxpayer filed and received an exemption from the requirements of the registration provisions in its home state, Taxpayer falls within the "notice of exemption" provision of Temp. Treas. Reg. § 1.448-1T(b)(2). The notice of exemption provision applies to the registration definition of farm syndicate in section 464(c)(1)(A). Consequently, Taxpayer is classified as a farm syndicate and thus a tax shelter, and cannot use the cash method of accounting.
2. Although A carried on breeding and research activities which were an integral part of Taxpayer's operation, A itself never sought nor received an exemption from the requirements of the registration provision of its home state. Furthermore, A included partners other than those comprising Taxpayer. Accordingly, A should not be treated as a farm syndicate and thus will not be a tax shelter. Consequently, A may continue to use the cash method of accounting.

### FACTS

Taxpayer is a State X partnership organized in Year 1 filing its first return for calendar year end in Year 1. Taxpayer was engaged in the production of Livestock and operated other ancillary facilities associated with the Livestock. Taxpayer's taxable year ending Year 7 is currently under examination.

There were two classes of partnership interests in Taxpayer: Senior Units ("SUs") and Junior Units ("JUs"). The SUs had no voting rights and conferred no right to participate in the management of Taxpayer. Holders of the SUs were entitled to a fixed rate of return and a liquidation preference, but did not share in Taxpayer's profits and losses. Holders of the JUs shared in Farms' profits and losses.

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On Date 1, Taxpayer applied to the State X Securities Commissioner (“Securities Commissioner”) for an exemption from the registration provisions of State X’s securities act regarding a limited offering of \$x of SUs within State X. About a month later, on Date 2, the Securities Commissioner approved the use of the limited offeree exemption under State X’s securities act.

On Date 3, Taxpayer again applied to the Securities Commissioner for an exemption from the registration provisions of the State X’s securities act, this time for a limited offering of \$y of JUs. A few weeks later, on Date 4, the Commissioner approved the use of the limited offeree exemption for the offering of JUs.

On Date 5, Taxpayer applied for a third time for an exemption from the registration provisions of the securities act, this time for a limited offering of \$z of SUs. About a month later, on Date 6, the Securities Commissioner approved the use of the limited offeree exemption for SUs offering.

On Taxpayer’s initial Form 1065 and for all subsequent years, Taxpayer has checked the box for the cash method of accounting and has in fact used the cash method on its tax returns.

On Date 7, Taxpayer transferred its breeding and research division to a newly formed partnership, A, in return for a substantial ownership interest. There were two other partners of A, but both held minimal ownership interests. Based on the facts developed to date, it appears that the breeding activities carried on by A were, and continue to be, an integral part of Taxpayer’s operation. A elected and in fact used the cash method on its tax returns.

At some point in Year 6, Taxpayer converted to a limited liability partnership and changed its name.

### LAW AND ANALYSIS

Section 448(a) limits the use of the cash receipts and disbursements method of accounting for certain taxpayers: C corporations, partnerships with a C corporation as a partner, and tax shelters. Accordingly, a partnership without a C corporation (as are Taxpayer and A) is not prohibited from using the cash method. Furthermore, partnerships in the farming business (as are Taxpayer and A), even if a C corporation is a partner, are not prohibited from using the cash method. Section 448(b)(1). Thus, for farming businesses, only the classification as a tax shelter under section 448(a) prevents the use of the cash method of accounting.

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Section 448(d)(3) provides in part that the term "tax shelter" has the meaning given such term by section 461(i)(3) (determined after application of paragraph (4) thereof). Section 461(i)(3), in turn, defines a "tax shelter" as:

- (A) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or state agency having the authority to regulate the offering of securities for sale,
- (B) any syndicate (within the meaning of section 1256(e)(3)(B)), and
- (C) any tax shelter (as defined in section 6662(d)(2)(C)(iii)).

Section 461(i)(4), however, provides that: in the case of the trade or business of farming (as defined in section 464(e)), in determining whether an entity is a tax shelter, the definition of farming syndicate in section 464(c) shall be substituted for subparagraphs (A) and (B) of paragraph (3).

Section 464(c)(1) defines the term "farming syndicate" as:

- (A) A partnership or any other enterprise other than a corporation which is not a S corporation engaged in the trade or business of farming, if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having authority to regulate the offering of securities for sale, or
- (B) a partnership or any other enterprise other than a corporation which is not an S corporation engaged in the trade or business of farming, if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.

Temp. Reg. 1.448-1T(b)(1)(i) provides that the term "tax shelter" includes any enterprise (other than a C corporation) if at any time (including taxable years beginning before January 1, 1987) interests in such enterprise have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale.

Temp. Treas. Reg. § 1.448-1T(b)(2), dealing with the requirement of registration, provides that for purposes of paragraph (b)(1)(i) of this section, an offering is required to be registered with a federal or state agency if, under the applicable federal or state law, failure to register the offering would result in a violation of the

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applicable federal or state law (regardless of whether the offering is in fact registered). In addition, an offering is required to be registered with a federal or state agency if, under the applicable federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable federal or state law (regardless of whether the notice is in fact filed).

Section 448(d)(8) provides that "the Secretary shall prescribe such regulations as may be necessary to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of this section." To date, no regulations have been promulgated under section 448(d)(8).

A tax shelter defined under section 6662(d)(2)(C)(ii) includes partnerships and other arrangements which have as the principal purpose of the partnership or other arrangement the avoidance or evasion of federal income tax.

State X's securities act generally provides that securities offered for sale have to be registered with the state or such offering will be unlawful. An exemption from registration is provided in the securities act. One of the terms of the exemption requires the offeror to get written approval prior to the making of the offer and the payment a filing fee. Although a taxpayer may receive an exemption from the registration requirements of the State X's securities act, it is still subject to the requirement of other sections of the act, including the suspension or revocation of an exemption, advertising controls, fraudulent practices, and investigations.

The issue in the present case is whether Taxpayer and A are "tax shelters" for purposes of section 448(a). That hinges on whether Taxpayer and A are "farm syndicates" for purposes of section 461(i)(4). If Taxpayer and A are farm syndicates, they are tax shelters, and they are therefore prohibited from using the cash method of accounting.

Section 448 does not itself define the term tax shelter but incorporates the definition given that term in section 461(i)(3), which provides that a tax shelter is any enterprise or entity coming within the definition of subparagraph (A),(B), or (C) of that paragraph. Subparagraph (A) defines a tax shelter as "any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or state agency having the authority to regulate the offering of securities for sale." Section 448, however, provides that in defining the term tax shelter, section 461(i)(3) is to be applied after application of section 461(i)(4). Section 461(i)(4) provides that in the case of the trade or business of farming, the definition of "farming syndicate" contained in section 464(c) is to be substituted for the definitions of tax shelter contained in section 461(i)(3)(A)&(B). As Taxpayer and A are in the trade or

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business of farming, the question of whether Taxpayer and A are tax shelters turns on whether they come within section 464(c)'s definition of a farming syndicate.

Section 464(c)(1) defines the term farming syndicate as any entity coming within the definition of subparagraph (A) or (B) of that paragraph. Subparagraph (A) defines a farming syndicate as "a partnership or any other enterprise other than a corporation which is not a S corporation engaged in the trade or business of farming, if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or state agency having authority to regulate the offering of securities for sale." This definition of a farming syndicate is virtually identical to that of a tax shelter contained in section 461(i)(3)(A). Both include within their scope entities in which interests have "at any time ... been offered for sale in any offering required to be registered with any Federal or state agency having the authority to regulate the offering of securities for sale." The two definitions differ only with respect to their descriptions of the types of entities to which they apply (*i.e.*, "any enterprise (other than a C corporation)" in the case of 461(i)(3)(A) versus "a partnership or any other enterprise other than a corporation which is not a S corporation engaged in the trade or business of farming" in the case of section 464(c)(1)(A)). (The definition of tax shelter in section 461(i)(3)(A) and of farming syndicate in section 464(c)(1)(A) are hereafter sometimes referred to as the "registration definitions.")

### **Issue 1**

Taxpayer will constitute a farm syndicate within the definition of subparagraph (c)(1)(A) of section 464 (and therefore a tax shelter for purposes of section 448) if at any time interests in Taxpayer were "offered for sale in any offering required to be registered with any Federal or state agency having authority to regulate the offering of securities for sale." There are no regulations under section 464 addressing what constitutes an "offering required to be registered with any Federal or state agency having authority to regulate the offering of securities for sale." However, the regulations under section 448 provide that "an offering is required to be registered with a federal or state agency if, under the applicable federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable federal or state law." Temp. Treas. Reg. § 1.448-1T(b)(2).

We agree with your analysis that the "notice of exemption" provision of Temp. Treas. Reg. § 1.448-1T(b)(2) is applicable to the registration definition of a farming syndicate found in subparagraph (A) of section 464(c)(1)(A). We agree that the provisions of the State X securities act which required Taxpayer to file an application for exemption from the act's registration provisions prior to making any offering of SUs or JUs constitute the type of requirement for "notice of exemption

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from registration" contemplated in Temp. Treas. Reg. § 1.448-1T(b)(2). Accordingly, we agree that Taxpayer is a farm syndicate within the definition of section 464(c)(1)(A) and therefore a tax shelter for purposes of section 448. Consequently, Taxpayer may not use the cash method of accounting.

## Issue 2

The question of whether A constitutes a farm syndicate as defined in section 464(c)(1)(A), and is therefore a tax shelter for purposes of section 448, poses a rather different set of issues than does the question of whether Taxpayer constitutes a farm syndicate. This is so because at no time have direct interests in A been offered for sale in any sale required to be registered with any Federal or state authority.

You argue that A may come within the registration definition of a farm syndicate under either of two theories: (1) A is an integral part of Taxpayer and thus should be treated for these purposes similar to or as part of Taxpayer and (2) although there are no regulations regarding related parties, the intent of the statute under section 448 is to prevent the circumvention of the rules by use of related party entities. See Section 448(d)(8).

Based on the facts developed to date, the activities of A (breeding and research) were, and continue to be, an integral part of Taxpayer's Livestock operations. In addition, Taxpayer has the substantial ownership interest in A. These factors could indicate that Taxpayer and A should be treated as parts of a single enterprise for purposes of applying the farm syndicate rules under section 464(c)(1)(A). Furthermore, there are some factors which suggest that A may have been created from Taxpayer for the purpose of avoiding the application of section 448, violating section 448(d)(8), including the fact that the portions of the operations which were spun-off were those which would be most substantially effected by conversion from the cash method of accounting and that there was no immediately apparent business purpose for the creation of A.

We believe that the facts are insufficient to hold that A is a farm syndicate under section 464(c)(1)(A) using a single enterprise theory. While A is an integral part of the operations of Taxpayer, it has different ownership interests and should be respected as a separate taxable entity. With respect to your second argument, we believe that the failure to issue regulations under section 448(d)(8) hampers the Service in trying to argue purpose and intent. We do not believe there is enough in the Code or the legislative history to section 448 to make section 448(d)(8) self-executing. Accordingly, we believe that A is not a farm syndicate under section

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464(c)(1)(A). Nor does A fall within the related party rules of section 448(d)(8). Therefore, A is not prevented from using the cash method of accounting.<sup>1</sup>

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<sup>1</sup>Because the question was not asked, we offer no view on the application of section 461(i)(3)(C) and whether it might be invoked to treat A as a tax shelter under section 448 and therefore prevent A from using the cash method of accounting.

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### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We feel strongly regarding our conclusion in Issue 1 that Taxpayer falls within the notice requirements of the sections 448, 461, and 464 and thus is a farm syndicate which cannot use the cash method of accounting.

We believe it is a close call regarding A and our conclusion in Issue 2. For entities merely to spin-off other entities, contribute part of operations to those entities, and thus avoid the application of the registration rules or any tax shelter rules gives us pause.

Your arguments for concluding that A should be treated as a farm syndicate are solid. If facts indicate that the other partners had no independence of Taxpayer or the partners in Taxpayer, then we believe there would be a stronger argument to disregard A. However, if there is any independence of the minority partners from Taxpayer, then we believe we should respect the separate entity of A and that the hazards of treating the two as one entity are substantial.

We were more persuaded by your section 448(d)(8) argument, regarding the related party rules. We concluded that the failure of regulations by the government would be held against the government. We also do not believe there is enough in the Code or the legislative history to section 448 to make section 448(d)(8) self-executing, distinguishing the cases cited in your incoming memorandum, including the Neumann v. Commissioner, 106 T.C. 216 (1996). Finally, we saw the absence of regulations as increasing the litigation hazards.

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Your arguments involving the purposes and intent of creating A are also applicable to another provision of section 448. Section 461(i)(3), defining tax shelter for purposes of section 448(a)(3), contains subsection (C). Section 461(i)(3)(C) defines tax shelter as any tax shelter as defined in section 6662(d)(2)(C)(iii). A tax shelter defined under section 6662(d)(2)(C)(ii) includes partnerships and other arrangements which have as the principal purpose of the partnership or other arrangement the avoidance or evasion of federal income tax. See Treas. Reg. § 1.6662-4(g)(2)(i) and -4(g)(2)(ii) [which defines principal purpose]. If further facts indicate that the sole reason for creating A was to avoid the application of section 448, then we recommend pursuing a shelter argument under section 448 by invoking section 461(i)(3)(C) (and section 448(d)(8)). On the other hand, as you know, arguments involving purpose and intent are fraught with hazards.

Please call if you have any further questions.

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