

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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CC:LB&I:HMT:DET:
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date: August 23, 2012

to: _____, Team Manager

from: Eric R. Skinner
LB&I Associate Area Counsel (Detroit)

subject: Response to Attorney Letter of Date 1
UIL: 6224.01-01; 453.00-00

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Taxpayer =
Year 1 =
Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Attorney =
Date 1 =
Date 2 =
Partnership =
X =

Facts:

Taxpayer (Taxpayer) sold her partnership interest in Year 1 for \$Amount 1. The terms of the sale called for "interest only payments" for X years, at which time the \$Amount 1 principal becomes due. At the time of the sale, the partnership, Partnership, had inventory of \$ Amount 3which was later sold for a profit of \$Amount 2. Of the \$Amount 2 sale amount, Taxpayer's share was in excess of \$Amount 4. Exam proposed a section 751 adjustment at the partnership level.

Section 751 requires the seller to recognize ordinary income to the extent the fair market value of the inventory exceeded its basis. As a result of this adjustment, Taxpayer was to pick up ordinary income of \$Amount 4 related to sale of the inventory. Taxpayer agreed to the section 751 adjustment and executed both part I of the Form 870 LT¹ and part II². Under part II of the 870LT, taxpayers waive the restriction provided by sections 6225(a) and 6213(a) and consent to the assessment and collection of any deficiency attributable to partner level determinations. Form 870LT part II further provides that if this part of the 870LT is signed, the treatment of the affected items and penalties and additions to tax attributable to the settled items will not be reopened in the absence of fraud, malfeasance or misrepresentation of fact. However, part II did not list the affected items covered by the agreement, any penalties, or any calculations as to how part I applied to Taxpayer's individual return. Part II contained the pre-printed boiler plate and nothing else. A Schedule of Adjustments was attached to the Form 870LT but it only contained adjustments to the partnership return (i.e. items related to part I).

The 870LT agreement in this case was countersigned and forwarded to the Service center. As Taxpayer did not file a return for Year 1, a substitute for return was prepared for her. Pursuant to the processing of the 870LT, Taxpayer has been assessed the failure to file and failure to pay penalties under section 6651 as well as the failure to pay estimated income tax penalty under section 6654.

Taxpayer, through her attorney, Attorney, now argues that she is entitled to Appeals rights for the section 751 issue as well as the penalties. Taxpayer argues that the section 751 adjustment is subject to section 453 installment reporting and that she could not have raised this "defense" to the adjustment at the partnership level.

In a letter dated May 14, 2012, Attorney takes issue with the Service on three fronts:

- (1) Form 870LT was obtained by misrepresentation of facts and hence should be disregarded;
- (2) The Service should follow its own procedures as set forth in Chief Counsel Notice 2009-011.
- (3) The assessment is not based on items contained in the partnership agreement but requires further determination at the partner lever.

¹ Part I of the Form 870LT is entitled "Agreement for partnership items and partnership level determinations as to penalties, additions to Tax and additional amounts and agreement for affected items".

² Part II of the Form 870LT is entitled "Offer of agreement for affected items and waiver of restrictions on assessment."

Although she did not list it as an item, Taxpayer also protests that the penalties in this case have been assessed and argues she was denied her rights under normal deficiency procedures to address the penalties.

1. The 870LT Was Not Obtained by Misrepresentation

A Form 870LT is a settlement agreement between the Secretary and one or more partners in a partnership with respect to the determination of partnership items for any partnership taxable year. Such agreements, often referred to as “closing agreements”, are governed under sections 6224(c) and 7121. “The standard that section 6224(c) prescribes for setting aside a settlement agreement is the same standard prescribed by section 7121(b) for setting aside a closing agreement.” H Graphics/Access Ltd. Partnership v. Commissioner, T.C. Memo. 1992-345. Specifically, an agreement will not be rescinded in the absence of fraud, malfeasance or misrepresentation of fact.

Taxpayer alleges that the 870LT herein was secured by the agent’s misrepresentation of facts. “Misrepresentation of facts” is not defined in the Internal Revenue Code, but a “misrepresentation” is defined as “a false statement of a substantive fact, or any conduct which leads to a belief of a substantive fact material to proper understanding of the matter in hand, made with intent to deceive or mislead.” Black’s Law Dictionary 956, 1001 (6th ed. 1990); see Brinkman v. Commissioner, T.C. Memo. 1989-217. A misrepresentation sufficient to set aside a closing agreement pursuant to section 7121(b) requires a showing that one party intentionally made incorrect or misleading representations regarding the express terms reflected in the proposed closing agreement and that such representations were relied upon by the other party to its detriment. Bennett v. Commissioner, T.C. Memo. 1988-557.

Taxpayer argues the 870LT was obtained by a misrepresentation of facts because Attorney was “not advised that the taxpayer was waiving her rights as a partner.” By her own statement, the agent did not make any incorrect or misleading representations related to the terms or effect of the proposed 870LT. While Taxpayer alleges misrepresentation and deception by the agent, she provides nothing in support of these allegations except the mere assertion that the agent never advised her of the consequences of signing the agreement. However, Attorney stated during a Date 2 call that he had not fully read the agreement previously. Attorney never raised any questions with the agent about the effect or operation of the agreement. He never indicated he did not understand the 870LT package given to him. He had no discussions with the agent about the agreement. What we have here is a unilateral mistake and not misrepresentation on the part of the Service. Section 7121 does not provide an exclusion for mistake or error of a party or representative and circumstances of error, mistake of fact, or negligence will not be sufficient to set aside a closing agreement. Brinkman, T.C. Memo 1989-217. Therefore, the Form 870LT was not obtained by misrepresentation and is valid.

2. [REDACTED]

[REDACTED]. Part II of the 870LT is entitled "Offer of Agreement for Affected items and Waiver of Restriction on Assessment." The "Instructions for Signing Form 870LT" (870LT instructions) provides:

Sign Part II (Offer of Settlement of Affected Items and Waiver of Restrictions on Assessment) of Form 870LT to settle the items that require partner level determinations (affected items, including penalties, additions to tax, and additional amounts, if any).

These items are also shown on the attached Schedule of Adjustments.

The agent provided the Form 870LT package to Attorney when he proposed the adjustment. [REDACTED]

3. Chief Counsel Notice 2009-11 Does Not Apply to this Case

Taxpayer urges the government to follow its own guidance, specifically Chief Counsel Notice 2009-11. Notice 2009-11 provides for protective assessments of affected items in TEFRA partnership cases. The notice recognizes that hazards exist in cases where there could be a question as to whether an item may be directly assessed following the partnership proceeding or whether an additional partner-level determination is needed. Notice 2009-11 applies in cases where a partner has reported a loss (or reduced gain) on the partner's individual return

after having sold an interest in a TEFRA partnership or an asset distributed from a TEFRA partnership. Due to the uncertainty that can occur in classifying an item as one that can be directly assessed versus one that requires an additional partner-level determination, and considering the hazards inherent in misclassifying an item, the notice advises the Service to make a protective assessment in addition to issuing an affected items notice of deficiency.

A portion of Notice 2009-11 states that deficiency procedures are generally necessary to determine loss or gain on the sale of a partnership interest given that outside basis in the partnership, necessary to compute loss or gain, requires a partner-level determination. See Petaluma FX Partners, LLC v. Comm’r, 591 F.3d 649, 654-55 (D.C. Cir. 2010). But see Thompson v. Commissioner, 137 T.C. No. 17 (2012). We agree that deficiency procedures would be required, but, Taxpayer waived deficiency procedures in part II of the Form 870LT, at least as to the agreed items.

4. The Section 751 Adjustment is Not Subject to Section 453 Treatment

Taxpayer takes the position that the “correct computational adjustment” is that the sale of the inventory should be reported using the installment method. However, the section 751 adjustment would not be subject to section 453 treatment. Section 453(b) defines installment sales. Section 453(b)(2)(B) provides “installment sale” does **not** include:

Inventories of personal property. A disposition of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year.

Further, Rev. Rul. 89-108 holds that under section 453, the income from the sale of a partnership interest may not be reported under the installment method to the extent it represents income attributable to the partnership’s substantially appreciated inventory which would not be eligible for the installment sale treatment if sold directly. The ruling further states that “the installment method is not available for reporting income realized on the sale of a partnership interest to the extent attributable to the substantially appreciated inventory which constitutes inventory within the meaning of section 453(b)(2)(B).”³ As such, the section 751 adjustment is not eligible for section 453 treatment. However, the remaining capital gain portion of Taxpayer’s gain from the sale of the partnership interest may be subject to section 453 treatment.

³ As a result of the amendments to sections 751(a)(2) and 751(d) by § 1062 of the Taxpayer Relief Act of 1997, the conclusion that in Rev. Rul. 89-108 that installment method reporting is not available, currently applies to income realized on the sale of a partnership interest on inventory items of the partnership as defined in section 751(d). The restriction to inventory items of the partnership that have “appreciated substantially in value” has been eliminated. This amendment to section 751 applies generally to sales, exchanges and distributions after August 5, 1997.

5. Taxpayer Should Be Given Appeals Rights As to the Penalties

Taxpayer argues that the penalties in this case were improperly assessed. She argues that the penalties relate to her individual return and the issues were not discussed at the partnership level. Rather, she posits the penalties are subject to deficiency procedures and the direct assessment of the penalties in this case deprived her of her rights under normal deficiency procedures. The penalties at issue are penalties under sections 6651 and 6654.

Under section 6665, penalties under sections 6651 and 6654 are normally not subject to deficiency procedures unless they are attributable to deficiencies which are subject to deficiency procedures. However, there is an exception for section 6654 penalties in cases where no return was filed. I.R.C. § 6665(b)(2). In instances where no return is filed, section 6654 penalties are treated as taxes and are subject to deficiency procedures. Therefore, in cases such as this where no return was filed and a Form 870 was signed the section 6651 penalties would normally not be subject to deficiency procedures but the section 6654 penalties would be. [REDACTED]

6. Conclusion

As stated above, the 870LT signed by Taxpayer was not obtained by misrepresentation. [REDACTED]

[REDACTED]. Taxpayer is not permitted to challenge the section 751 adjustment contained in part I of the Form 870LT.

If you have any questions, please contact the undersigned at 313-628-3116.

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By: _____
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