

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

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subject: **Period of Limitations for TEFRA Partnership Items**

This Chief Counsel Advice responds to your request for assistance dated September 4, 2003. In accordance with I.R.C. § 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

LEGEND

Individual A =

Individual B =

LLC1 =

LLC2 =

S Corporation =

Partnership =

Year 1 =

ISSUE

May the Service initiate a TEFRA partnership proceeding for Year 1 when the period for assessment has expired for all partners for Year 1, but the partners may have claimed losses attributable to Year 1 partnership items in subsequent open years?

CONCLUSION

Yes.

FACTS

In Year 1, individuals A and B formed a partnership (“the partnership”). The three partners were an S corporation, and two limited liability companies, LLC1 and LLC2. A and B were the sole shareholders of the S corporation. A was the sole owner of LLC1. B was the sole owner of LLC2. LLC1 and LLC2 are disregarded entities under Treas. Reg. § 1.7701-3. The partnership is subject to the unified audit and litigation procedures of I.R.C. §§ 6221 through 6234 (TEFRA).

LLC1 and LLC2 opened brokerage accounts and sold short positions in Treasury notes. They transferred the brokerage accounts, which included the proceeds from the short position and the obligation to close the short position, to the partnership. The partnership then closed the short sale position using the contributed proceeds.

In a separate transaction, the partnership purchased foreign currencies. The partnership then liquidated at the end of Year 1, distributing its assets (the foreign currencies) to the three partners. A and B treated their bases in the distributed currencies as equivalent to their outside basis in their partnership interest. A and B included the cash proceeds from the short sale in the computation of their bases without reducing their bases by the short sale obligation assumed by the partnership or the partnership’s payment of this obligation. Individuals A and B then contributed the currencies to their S corporation.

All of the above occurred in Year 1. The period of limitations on assessment has expired for Year 1 for all partners.

In a subsequent taxable year, A and B claimed a loss attributable to the inflated bases in the currencies distributed by the partnership. The loss was generated by either the sale of the currencies or the sale of stock in the S corporation. The period for assessment may be open for one or both partners in the year the loss was claimed.

At issue is whether the Service may open a proceeding under the unified audit and litigation procedures of I.R.C. §§ 6221 through 6234 (TEFRA) to adjust partnership items in Year 1 for the purpose of assessing tax in subsequent open years of A and B. Specifically, the Service would adjust partnership items by treating the short position obligation as a liability assumed by the partnership. The adjustment would also treat

the partnership's assumption and payment of the liability as a distribution of cash to the partners under sections 752(b) and 705(a)(2). This would affect A and B's outside bases in their partnership interests and their consequent bases in the currencies distributed by the partnership. The adjusted bases in the distributed currencies would be used to recalculate the loss claimed by the partners in years for which the period for assessment has not expired.¹

LAW AND ANALYSIS

The tax treatment of partnership items is determined at the partnership level pursuant to the unified audit and litigation procedures set forth in sections 6221 through 6234.

Section 6221 provides that the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level.

Section 6231(a)(3) provides that partnership items are defined by regulations. Treas. Reg. § 301.6231(1)(3)-1(a)(1)(v) includes in the definition of partnership items the partnership aggregate and each partner's share of partnership liabilities. See *Dakotah Hills v. Commissioner*, T.C. Memo. 1996-35 (each partner's share of partnership liabilities is a partnership item). Treas. Reg. § 301.6231(a)(3)-1(a)(4) and -1(c) further defines a partnership item as including partner contributions to the partnership and partnership distributions to the partners.

Section 6226(c)(1) provides that, if a partnership action is brought under either section 6226(a) or (b), each person who was a partner in such partnership at any time during the year in issue shall be treated as a party to such action.

Section 6226(d)(1)(B) further provides that a partner is not a party to the proceeding after the day on which the period for assessing any tax attributable to partnership items has expired. Therefore, a TEFRA proceeding can be initiated, and a partner has an interest in the outcome, as long as the period for assessing "any tax attributable to partnership items" is open. I.R.C. § 6226(d)(1)(B).

Section 6501(a) sets forth the general limitation on assessment and provides that, "[e]xcept as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within three years after the return was filed (whether or not the return was filed on or after the date prescribed)." This subsection further provides that the term "return" means the return required to be filed by the taxpayer (and does not

¹ Other substantive grounds may also be raised in the TEFRA proceeding as provided in CCDM Notice CC-2003-020 (Notice 2000-44 Son of Boss Tax Shelter).

include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit).²

Under these provisions, an assessment must be made within three years of the due date for filing or the actual date of filing of the return, whichever is later. I.R.C. § 6501(b)(1). For purposes of section 6501(b)(1), the return at issue is the return of a partner or shareholder and not the return of the flow-through entity. The Supreme Court in Bufferd v. Commissioner, held "that the limitations period within which the Internal Revenue Service must assess the income tax liability of an S corporation shareholder runs from the date on which the shareholder's return is filed." Bufferd, 506 U.S. at 533. As the Court noted, "returns that 'lack the data necessary for the computation and assessment of deficiencies' generally should not be regarded as triggering the period of assessment." Bufferd, 506 U.S. at 528 quoting Automobile Club of Mich. v. Commissioner, 353 U.S. 180, 188 (1957) (footnote omitted). Accordingly, the return of the flow-through entity does not trigger the running of a partner's period of limitations.

Section 6501(n)(2) provides: "[f]or an extension of period in the case of partnership items (as defined in section 6231(a)(3)), see section 6229."

Section 6229(a) provides that the period for assessing tax which is attributable to any partnership item (or affected item) shall not expire before 3 years after the later of the date the partnership files its return, or the last day for filing the return for such year. In other words, section 6229 extends the section 6501 limitation period for partnership items for each partner.

The court so held in Rhone-Poulenc v. Commissioner, 114 T.C. 533 (2000). Specifically, the court held that the period for assessing partnership items is governed by each partner's separate period for assessment under section 6501. Id. at 542. The court held that section 6229 merely serves to extend each partner's section 6501 period to a minimum expiration date. Id. Therefore, section 6229 merely provides a buffer period during which the period under section 6501 for assessing each partner will not expire. Id. at 543. The Federal Court of Appeals for the District of Columbia Circuit recently agreed with this holding. Andantech v. Commissioner, 331 F.3d 972, 977 (D.C. Cir. 2003).

² The last sentence of this provision was added by section 1284 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34 and "clarifies that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit." Conf. Rep. No 105-220 at 702-703 (1997). Though the Act sets forth a prospective effective date, this provision does not substantively alter the law. See Bufferd v. Commissioner, 506 U.S. 523 (1993).

In the present case, the Service intends to assess tax against the partners for taxable years subsequent to Year 1. The tax is attributable to the adjustment of partnership items from Year 1. The partnership items being adjusted are partnership liabilities and the treatment of the partnership's assumption and payment of the liabilities as a distribution to A and B. An increase in distributions to A and B will reduce A and B's bases in their partnership interests. See I.R.C. §§ 752(b), 733 and 705(a)(2).

This will result in smaller bases in the currencies received by the partners in the liquidating distribution. I.R.C. § 732(b). The smaller bases will result in a smaller loss upon sale of the currencies or sale of the stock in the S corporation. The tax attributable to the loss disallowance is, thus, attributable to the adjustment of partnership items from Year 1. Since the period for assessing tax for the loss year is open, and the loss is attributable to partnership items emanating from Year 1, the period for assessing tax attributable to Year 1 partnership items is open. Thus, the partners will be parties to a TEFRA proceeding initiated for Year 1. I.R.C. § 6226(d)(1)(B). As parties, A and B may be assessed based on a TEFRA proceeding for Year 1, notwithstanding that the period for assessing any tax has otherwise expired for Year 1 for each of the affected partners.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call _____ if you have any further questions.