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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
January 21, 2000

Number: **200011048**
Release Date: 3/17/2000
CC:DOM:FS:PROC
TL-N-5758-99WLI2
UILC: 6231.05-00
6231.06-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE SERVICE CENTER ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, BROOKLYN
CC:NER:BRK

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: TEFRA Assessment Procedure for Tax Attributable to
Partnership Cancellation of Indebtedness

This responds to your request for Significant Advice, dated November 15, 1999, in connection with a question posed by the TEFRA Coordinator of the Brookhaven Service Center.

ISSUE

Whether the tax liability of a partner that is attributable to the increase of cancellation of indebtedness income of a partnership should be assessed by way of computational adjustment or through the deficiency procedures.

CONCLUSION

The tax liability of a partner that is attributable to the increase of cancellation of indebtedness income of a partnership should be assessed through the deficiency procedures.

FACTS

Following a TEFRA proceeding, adjustments to a partner's tax liability (assessments) are made in one of two manners. If the assessment is attributable to a partnership item, the assessment is typically made by way of a computational

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adjustment. If the assessment is attributable to an affected item, it must be determined whether any partner level determinations are required. If no partner level determinations factual are required, the assessment is also made by way of computational adjustment. If a partner level factual determination is required, a statutory notice of deficiency generally must be issued. Historically, the Service Centers have assessed tax attributable to income from the cancellation of indebtedness that is flowed through to taxpayers from a TEFRA entity by way of a computational adjustment. The question has arisen as to the proper characterization, and thus, the proper assessment procedure, for an adjustment attributable to income from the cancellation of indebtedness flowing from TEFRA entity.

LAW AND ANALYSIS

A dichotomy exists “between, on the one hand, the procedures applicable to the determination and redetermination of deficiencies and, on the other hand, the procedures applicable to the administrative adjustment and judicial readjustment of partnership items.” Maxwell v. Commissioner, 87 T.C. 779, 787 (1986) (emphasis in original). Items of partnership income, loss, deduction, or credit that affect each partner are to be determined at the partnership level. Id.; I.R.C. § 6221. “Respondent has no authority to assess a deficiency attributable to a partnership item until after the close of a partnership proceeding.” Id. at 788; I.R.C. § 6225. Once the partnership proceeding has concluded, partnership items and computational affected items may be assessed by computational adjustment; whereas a statutory notice of deficiency must be issued for affected items that require factual determinations. N.C.F. Energy Partners v. Commissioner, 89 T.C. 741, 744 (1987); I.R.C. § 6230(a)(2)(A)(i). Thus, our threshold question is whether the assessment of tax attributable to income from the cancellation of indebtedness is a partnership item or an affected item.

“[A] ‘partnership item’ means any item required to be taken into account for the partnership’s taxable year to the extent prescribed by [the Commissioner’s] regulations as an item that ‘is more appropriately determined at the partnership level’.” Maxwell v. Commissioner, 87 T.C. 783 (1986) (quoting I.R.C. § 6231(a)(3)) “An item whose existence or amount is dependent on any partnership item is an affected item.” Id. at 791. Determination of the amount or the existence of cancellation of indebtedness income of a partnership is more appropriately determined a the partnership level, and the partnership is required to take it into account under subtitle A. See I.R.C. § 6231(a)(3). Thus, the amount of cancellation of indebtedness income of the partnership is a partnership item to which the TEFRA procedures, rather than the deficiency procedures apply. I.R.C. § 6231(a)(3). Furthermore, the partnership’s allocation of partnership items among the partners is a partnership item. Treas. Reg. § 301.6231(a)(3)-1(a). Thus, both the partnership’s aggregate and each partner’s distributive share of the cancellation

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of indebtedness income are partnership items. The present issue, however, is whether the tax attributable to the increase of cancellation of indebtedness can be assessed computationally.

Generally, an item of partnership income is a partnership item, of which each partner's distributive share can be computed and the correlative increase in tax assessed through a computational adjustment. See Maxwell, 87 T.C. at 787; Crowell v. Commissioner, 102 T.C. 683, 689 (1994); I.R.C. § 6231(a)(3); Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i). Income from discharge of indebtedness, however, may be excluded from gross income in a variety of circumstances. See generally I.R.C. § 108. In the case of a partnership, the exclusion provisions are to be applied at the partner level. I.R.C. § 108(d)(6). Thus, the inclusion of the cancellation of indebtedness income at the partner level includes nonpartnership item factors. The inclusion of cancellation of indebtedness income is an affected item, because it includes both partnership item and nonpartnership item components. See I.R.C. §§ 6231(a)(3) and (a)(5).

Next, it must be determined whether the inclusion into income of each partner's share of cancellation of indebtedness income is an affected item requiring factual determinations at the partner level. Whether an affected item may be assessed through a computational adjustment depends on whether the adjustment made to a partner's income "require[s] no additional factual determinations at the partner level other than a computation." Bob Hamric Chevrolet, Inc. v. United States, 849 F.Supp. 500, 512 (W.D.Tex. 1994) (emphasis in original). If additional factual determinations must be made at the partner level, then a notice of deficiency must be issued prior to assessment. I.R.C. §§ 6230(a)(2)(A)(i) and 6213(a).

Among the reasons cancellation of indebtedness income may be excluded from computing a partner's tax liability is if the partner is insolvent. I.R.C. § 108(a)(1)(B). The determination as to whether the partner is insolvent is a factual determination that must be made at the partner level. I.R.C. § 108(d)(6). Therefore, the Service is required to follow the deficiency procedures before making an assessment of tax attributable to cancellation of indebtedness income. I.R.C. § 6230(a)(2)(A)(i).

Please call if you have any further questions.

cc: Regional Counsel, Northeast Region
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