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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Associate Area Counsel (Strategic Litigation - Chicago)
(Large and Mid-Size Business)
CC:LM:RFP:SL:CHI

by Curt J. Wilson

FROM: ASSISTANT CHIEF COUNSEL (ADMINISTRATIVE
PROCEDURES & JUDICIAL PROCESS) CC:PA:APJP

SUBJECT: Using partnership items to determine a partner's outside basis

This Field Service Advice responds to a request of October 10, 2000. 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.

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LEGEND:

X =

YEAR 1 =

YEAR 2 =

Y =

\$A =

\$B =

\$C =

\$D =

\$E =

\$F =

LP =

SC =

Z =

ISSUES:

- 1) Whether respondent should assert that the Tax Court has jurisdiction under I.R.C. § 6214(b) to consider proposed adjustments to partnership items of a TEFRA partnership for partnership years not before the court in the course of determining a partner's basis in his or her partnership interest.
- 2) What consideration should respondent give to the partnership items of multi-tiered TEFRA partnerships for the purpose of determining a partner's basis in a partnership interest?

CONCLUSION:

- 1) Respondent should not rely upon I.R.C. § 6214(b) as a basis for considering proposed adjustments to partnership items of a TEFRA partnership for partnership years not before the court in this deficiency proceeding.
- 2) Respondent must consider, but generally may not adjust, any partnership items of a partnership that may affect the determination of a partner's basis in a partnership interest.

FACTS:

During YEAR 2 , LP (a partnership subject to administrative and judicial procedures in I.R.C. §§ 6621 through 6234, i.e., a TEFRA partnership) was liquidated and distributed its assets to a new partnership formed by those persons holding direct and indirect partnership interests in LP. During YEAR 2 and the relevant preceding years, LP was a partnership between X, Z, and SC. SC was the general partner, while X and Z held the limited partnership interests. X was the sole

shareholder in SC, a corporation subject to tax under Subchapter S of the Internal Revenue Code.

To acquire his partnership interest in LP in YEAR 1, X had contributed to LP depreciable and nondepreciable real property with a fair market value of \$A, on which there was a secured debt of \$B to an unrelated third party. X had acquired the property for \$C and had taken depreciation of \$D on the property when the contribution to LP was made. When LP was liquidated, the property had a fair market value of \$E. For the tax years between LP's receipt of the property and its distribution, LP reported additional depreciation and made payments to reduce the amount of the secured debt.

The Service issued a notice of deficiency to X and Y in which the Service attributed a basis of \$F to X for his partnership interest in LP at the time of LP's liquidation. The Tax Court petition alleges that the Service is required to allow X a higher basis in LP based upon the partnership items reported by LP since X's acquisition of his partnership interest. X further alleges that he is entitled to use the alternative method of determining his basis if his substantiation of basis under § 705(a) is deemed insufficient.

LEGAL ANALYSIS

The partnership provisions in Title IV of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, sec. 401-407, 96 Stat. 324, 648-71, established a unified audit and litigation process under Code sections 6221 through 6233 for determining the tax treatment of partnership items at the partnership level. For partnership tax years beginning after September 3, 1982, these TEFRA provisions created a statutory dichotomy between the procedures applicable to the determination of tax deficiencies and overpayments under sections 6211 through 6215 of the Code and the procedures applicable to the administrative adjustment and judicial readjustment of partnership items under sections 6621 through 6233. See Addington v. Commissioner, 205 F.3d 54 (2d Cir. 2000), aff'g Sann v. Commissioner, T.C. Memo. 1997-259; Randell v. United States, 64 F.3d 101, 103 (2d Cir. 1995), cert. denied, 519 U.S. 815 (1996); and Maxwell v. Commissioner, 87 T.C. 783 (1986). The TEFRA unified audit rules for partnerships apply to taxable years of partnerships, such as LP's YEAR 2, that began after September 3, 1982.

In the interest of providing consistent treatment for all partners in a partnership, the TEFRA partnership provisions require adjustments to "partnership items" to be made at the partnership level in a separate TEFRA partnership proceeding. I.R.C. § 6221. The Service is generally prohibited from assessing a deficiency regarding a partnership item without first making the appropriate adjustments to the partnership items in a partnership level proceeding. I.R.C. § 6225(a). The Service, however, may adjust nonpartnership items, including affected items, under the

existing deficiency procedures. See Jenkins v. Commissioner, 102 T.C. 550 (1994); Maxwell v. Commissioner, 87 T.C. 783, 787 (1986).

Section 6231(a)(3) defines a “partnership item” as any item that is required to be taken into account for the partnership’s taxable year under any provision of the Code to the extent that Service regulations provide that the item is more appropriately determined at the partnership level than at the partner level. N.C.F. Energy Partners v. Commissioner, 89 T.C. 741 (1987). Treasury regulations define partnership items to include “the partnership’s aggregate and each partner’s share of . . . [i]tems of income, gain, loss, deduction or credit of the partnership.” Treas. Reg. § 301.6231(a)(3)-1(a)(1). Partnership items also include factors affecting the determination of other partnership items. Treas. Reg. § 301.6231(a)(3)-1(b). Thus, the determination of “each partner’s share” of a partnership’s income, gain, loss, deductions or credits is a partnership item that can only be adjusted in a partnership proceeding. See Hambrose Leasing 1984-5 Limited Partnership v. Commissioner, 99 T.C. 298 (1992) (allocating partners’ share of losses); Woody v. Commissioner, 95 T.C. 132 (1990) (allocating guaranteed payments among partners).

An affected item is any item on a partner’s return to the extent that it is affected by a partnership item. I.R.C. § 6231(a)(5); Jenkins v. Commissioner, 102 T.C. 550, 554 (1994). Affected items can be either computational adjustments (which the Service can make to reflect the adjustment of partnership items without issuing a notice of deficiency), I.R.C. § 6231(a)(6), or items that require a factual determination at the individual partner level (using the deficiency procedures). See N.C.F. Energy Partners v. Commissioner, 89 T.C. 741 (1987). Either type of affected item may be determined only after the partnership items or items upon which it is based are established.

By definition, affected items are not partnership items; thus, they are not subject to determination at the partnership level. Section 6230(a)(2)(a)(i) authorizes the Service to issue a notice of deficiency for affected times that require partner level determinations. Further, if the Service is not contesting the partnership items as reported by the partnership, the Service is not required to conduct an examination of the partnership returns before issuing a notice of deficiency to contest an affected item. See Jenkins v. Commissioner, 102 T.C. 550, 566 (1994); Roberts v. Commissioner, 94 T.C. 853 (1990). In Jenkins, a partner terminating her interest in a partnership reported a distribution she received from the partnership for agreeing not to exercise rights to have premiums waived under a life insurance policy as being exempt from income under I.R.C. § 104(a). The partnership reported the distribution as a guaranteed payment under I.R.C. § 707(c). After the taxpayer filed a notice of inconsistent treatment, the Service issued a notice of deficiency to the taxpayer disallowing the tax exempt treatment of the payment under I.R.C. § 104(c). The taxpayer claimed that the notice was invalid because the Service sought to make a partnership adjustment without first conducting a

partnership audit under the TEFRA procedures. The Tax Court, in considering the Service's handling of the notice of inconsistent treatment, agreed with the Service that the determination did not involve an adjustment to a partnership item and that it was properly raised in a notice of deficiency. Entitlement to tax exempt treatment under section 104(c) was best determined at the partner's level. As long as the Service did not contest the partnership's reported characterization of the distribution under section 707(c), the Service was not required to follow the TEFRA audit procedures. The Court concluded that the claimed exemption from tax under section 104(c) was an affected item that the Service properly addressed in a notice of deficiency.

In Roberts v. Commissioner, 94 T.C. 853 (1990), the taxpayers claimed losses from three TEFRA partnerships. The Service did not conduct TEFRA audits for any of the partnerships and the statute of limitations expired without any partnership level adjustments being made. The Service issued a notice of deficiency to the taxpayer denying the carryback of the taxpayers' reported share of partnership losses because the taxpayers were not "at risk" for the losses under section 465. Finding that the "at risk" determination was an affected item and that acceptance of the partnership return as filed served as the outcome of any partnership proceeding, the Tax Court found it had jurisdiction to consider the affected item in the deficiency case before it.

In this case, the Service has not proposed any adjustment to the income and losses reported by LP, either on its Form 1065, U.S. Partnership Return of Income or on the Schedule K-1 it issued to X for each of the years at issue or for any related years. Instead, the Service is contesting X's basis in LP, for purposes of determining the amount of the gain or loss to be recognized by X on the dissolution of LP and its distribution of assets. The Service's determination does not affect the amount of the income, losses, or other partnership items reported by LP for the year at issue. As in Jenkins v. Commissioner and in Roberts v. Commissioner, that determination would properly be made in a notice of deficiency.

ISSUE 1: Tax Court's jurisdiction under I.R.C. § 6214(b)

In determining X and Y's tax liability, including overpayments, for YEAR 2, the court has jurisdiction to consider transactions in other years that affect the taxes in those years. Section 6214(b) gives the Tax Court jurisdiction —

to consider such facts with relation to other years and other quarters as may be necessary correctly to redetermine the amount of [the deficiency for the year before the court], but in so doing shall have no jurisdiction to determine whether or not the tax for any other year has been overpaid or underpaid.

The Tax Court has previously held that it may consider whether the taxpayer actually incurred the loss as claimed or would have exhausted the loss by using it in years other than the year before the court when a taxpayer claims the benefits of the carryover of a net operating loss to the year before the court. Leitgen v. Commissioner, 82-2 U.S.T.C. ¶ 9553 (8th Cir. 1982), aff'g T.C. Memo. 1981-525 (1981) (Substantiation of claimed 1972 NOL was considered in determining whether loss was available to be carried forward to 1973, 1974 and 1975); Phoenix Coal Co. v. Commissioner, 231 F.2d 420 (2d Cir. 1956), aff'g T.C. Memo. 1955-28 (1955) (Adjustments to income in 1945 were considered in determining how much of 1947 NOL was available for use in 1946); Lone Manor Farms, Inc. v. Commissioner, 61 T.C. 436, 440 (1974), aff'd without published op., 510 F.2d 970 (3d Cir. 1975) (NOLs available for use in 1967 could not be used in 1969); and ABKCO Industries, Inc. v. Commissioner, 56 T.C. 1083 (1971), aff'd on other grounds, 482 F.2d 150 (3d Cir. 1973) (Commissioner could recompute income for closed short taxable year to determine how much of carried back NOL was available in a succeeding year).

Whether the respondent could question adjustments to partnership items reported by LP to X in the years preceding YEAR 2, however, presents another issue. Any adjustments to the partnership items reported by LP and of X's share of those items would involve the redetermination of losses incurred and reported by the partnership. Under the TEFRA procedural rules, the partnership items reported on LP's partnership returns are partnership items that can only be redetermined in a TEFRA partnership action. See sections 6221 through 6233. On this issue, section 6214(b) appears to be in conflict: does the Tax Court's authority to consider facts with relation to the taxes for other years or calendar quarters under section 6214(b) extend to the consideration of partnership items arising in those years? In at least one case, Durrett v. Commissioner, T.C. Memo. 1994-179, the Tax Court concluded that section 6214(b) could be applied to make adjustments to partnership items. In that case, the taxpayers filed a motion asking to amend the petition to raise the carryback of their share of reported partnership losses from another tax year. The Service countered by arguing that it should be able to challenge the validity of the claimed partnership losses in the pending deficiency proceeding. The court agreed that it had authority to consider adjustments to the partnership losses under section 6214(b) as part of its consideration of the taxpayer's claimed carryback of the losses, if it agreed to consider the carryback. Finding that raising the new issue (including the partnership adjustments) was unduly burdensome, the court denied the taxpayer's petition to raise the new issue.

In its opinion in Maxwell v. Commissioner, 87 T.C. 783, 789 (1986), however, the Tax Court distinguished between the consideration of adjustments to partnership items and the consideration of affected items. Mr. Maxwell, one of the taxpayers in that case, formed a limited partnership in December 1982, with 13 limited partners and himself as the general partner. While a partnership audit for the 1982 tax year was pending, the Service issued a notice of deficiency to the Maxwells determining

deficiencies and additions to the tax for the years 1979, 1980, 1981, and 1982. The proposed deficiencies for 1982 resulted in part from the disallowance of Mr. Maxwell's claimed distributive share of partnership losses and investment tax credits for 1982. The 1979 and 1980 deficiencies were attributable to the Maxwells' claimed carryback of part of the disallowed investment tax credit to those years. The Service had not completed the partnership audit and had not issued an FPAA to the partners when the notice of deficiency was issued.

As the parties were reaching a basis for settling the case, the Service reconsidered the notice of deficiency and concluded that the partnership's losses and investment tax credits were partnership items. The Service filed a motion to strike the partnership items and affected items from the petition for lack of jurisdiction on the grounds that the Tax Court had no jurisdiction to consider them, unless they were raised in a TEFRA petition filed after an FPAA had been issued for the partnership. The court granted the motion. In explaining its lack of jurisdiction, the court analyzed the purpose underlying the TEFRA partnership audit process and raised several key points:

- The Service has no authority to assess a deficiency attributable to a partnership item until after the close of the partnership proceeding, (section 6225(a)), and may be enjoined from making premature assessments. Maxwell, at 788.
- All nonpartnership matters on a partner's income tax return continue to be subject to existing rules for administrative and judicial resolution of the partner's tax liability. Neither the Service nor the taxpayer are permitted to raise nonpartnership items in the course of a partnership proceeding nor may partnership items be raised in proceedings relating to nonpartnership items of a partner, unless the partnership items are converted to nonpartnership items. H. Rep. 97-760, 97th Cong., 2d Sess. at 611 (1982), 1982-2 C.B. 600 at 668; Maxwell, at 788.¹
- Because section 6226 makes the issuance of an FPAA a condition precedent to the exercise of its jurisdiction over a partnership action, the Tax Court has no jurisdiction over partnership items until an FPAA is issued for the partnership. Maxwell, at 789.
- Losses and credits claimed by a partnership are "partnership items," unless some provision of the statute transmits them into

¹ None of the partnership items reported on the partnership returns filed by LP have been converted into nonpartnership items under section 6231.

“nonpartnership items.” Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i) and (vi)(A). Maxwell, at 790.

- The existence or the amount of carrybacks of the investment tax credits or NOLs from the year in which the partnership claimed the credits or losses to other years are affected items, as defined in section 6231(a)(5), that are dependent upon the determination of a partnership item -- such as the amount of the partnership loss or the credit – and cannot be considered until the partnership item is resolved. Maxwell, at 790-91.

The Tax Court’s analysis in Maxwell, if applied to this case, would prohibit the consideration of adjustments to the partnership items. The Tax Court may consider the partnership items only in a partnership proceeding, not in a deficiency proceeding, even if an FPAA has been issued. Trost v. Commissioner, 95 T.C. 560, 564 (1990) (partner could not reduce his liability for tax on nonpartnership items by using items attributable to a partnership) . If there have been no partnership proceedings in which an FPAA might be timely issued and there can no longer be a partnership proceeding under the normal statute of limitations, the only possible outcome of the partnership proceeding is the acceptance of the partnership return as filed. Roberts v. Commissioner, 94 T.C. 853, 860 (1990). In this case, where the Service has not issued an FPAA to question the partnership items reported by LP, the Court’s analysis in Maxwell would lead to the conclusion the Tax Court does not have jurisdiction to adjust those items in a deficiency proceeding.

ISSUE 2: Determining a partner’s basis in the partner’s partnership interest

Section 705 of the Code governs the determination of a partner’s basis in the partner’s partnership interest. A partner is required to determine the adjusted basis of the partner’s partnership interest only when necessary to determine the partner’s or any other person’s tax liability. Ordinarily, this determination is made as of the end of a partnership’s taxable year. However, where there has been a sale or exchange of all or a part of a partner’s partnership interest or a liquidation of a partner’s entire interest in a partnership, the adjusted basis of the partner’s interest should be determined as of the date of sale or exchange or liquidation. The adjusted basis of a partner’s interest in a partnership is determined without regard to any amount shown in the partnership books as the partner’s “capital,” “equity,” or similar account.

Under Treas. Reg. § 1.705-1(a)(2), a partner’s basis in the partner’s partnership interest is determined by taking the original basis of the partner’s partnership interest determined under either §722 (relating to contributions to a partnership) or § 742 (relating to transfers of a partnership interest), as applicable, and increasing

that original basis by any subsequent partnership contributions under § 722 and by the sum of the partner's distributive share for the taxable year and prior taxable years of:

- (i) Taxable income of the partnership as determined under § 703(a),
- (ii) Tax-exempt receipts of the partnership, and
- (iii) The excess of the deductions for depletion over the basis of the depletable property, unless the property is an oil or gas property the basis of which has been allocated to partners under § 613A(c)(7)(D).

A partner's basis in the partner's partnership interest is then decreased under § 733 (but not below zero), by the amount of any money distributed to the partner, and the amount of the basis to such partner of distributed property other than money, and by the sum of the partner's distributive share for the taxable year and prior taxable years of:

- (i) Partnership losses (including capital losses), and
- (ii) Partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures.

Finally, a partner's basis in the partner's partnership interest is adjusted by any change in the partner's share of the partnership's liabilities under § 752.²

In certain cases, however, the adjusted basis of a partner's interest in a partnership may be determined by reference to the partner's share of the adjusted basis of partnership property which would be distributable upon termination of the partnership. Treas. Reg. § 1.705-1(b). A taxpayer may use the alternative rule to determine the adjusted basis of the partner's interest where circumstances are such that the partner cannot practicably apply the general rule set forth in § 705(a), or where, from a consideration of all the facts, it is, in the opinion of the Commissioner, reasonable to conclude that the result produced will not vary substantially from the result obtainable under the general rule. Where the alternative rule is used, adjustments may be necessary in determining the adjusted basis of a partner's interest in a partnership. Adjustments would be required, for

² Section 705 also contains some special basis adjustment rules that, based on the facts provided, may not be relevant here. See Treas. Reg. § 1.705-1(a)(4) and (5); Rev. Rul. 99-57, 1999-51 I.R.B. 678, Rev. Rul. 96-11, 1996-1 CB 140, Rev. Rul. 96-10, 1996-1 CB 138, and Rev. Rul. 84-15, 1984-1 CB 158.

example, in order to reflect in a partner's share of the adjusted basis of partnership property any significant discrepancies arising as a result of contributed property, transfers of partnership interests, or distributions of property to the partners.³

Section 722 provides that the basis of a partnership interest acquired by a contribution of property, including money, to the partnership is the amount of the money and the adjusted basis of the property to the contributing partner at the time of contribution. This basis amount is increased by the amount of gain, if any, the contributing partner recognized under § 721(b) on the contribution.

Section 752 governs the treatment of certain liabilities. In general, any increase in a partner's share of the partnership's liabilities (or any increase in a partner's individual liabilities by reason of the partner's assumption of the partnership's liabilities) is considered as a contribution of money to the partnership by the partner. Section 752(a). Similarly, any decrease in a partner's share of the partnership's liabilities (or any decrease in a partner's individual liabilities by reason of the partnership's assumption of the partner's liabilities) is considered as a distribution of money to the partner by the partnership. Section 752(b).

Thus, for purposes of the TEFRA partnership provisions, a partner's basis in that partner's partnership interest is an affected item under section 6231(a)(5). The calculation of basis is an affected item because it is, in part, based on factors that are considered partnership items under section 6231(a)(3). See Treas. Reg. § 301.6231(a)(5)-1T(b) (stating that basis in a partnership interest is an affected item to the extent that it is not a partnership item). For example, although certain items considered in calculating a partner's initial basis in the partner's partnership interest are not partnership items, see section 722 or section 742, other components of the basis calculation would require partnership level determinations under section 705 (partnership taxable income; partnership tax-exempt receipts; partnership depletion, partnership's basis in depletable property; partnership loss; partnership nondeductible and noncapital expenditures; partnership liabilities, and, if applicable, the partnership items discussed in footnote 2, supra).

In this case, the determination of X's basis in his partnership interest at the time the partnership liquidated is an affected item. The Tax Court would have jurisdiction to consider and adjust the nonpartnership components of X's basis in his partnership

³In this case, X has not shown that the use of the alternative method for determining basis is appropriate. A mere allegation as an alternative theory is not sufficient grounds to apply the alternative method. See Coloman v. Commissioner, 540 F.2d 427, 431 (9th Cir. 1976)(Stating that taxpayers failed to show that "circumstances were such that the taxpayers could not 'practicably' apply the general rule of Section 705(a).").

interest ---- those factors X used to compute his initial basis in his partnership interest under section 722. The Tax Court, however, would not have jurisdiction to adjust the partnership item components of X's basis in his partnership interest ---- those factors X used to adjust his initial basis in accordance with section 705. Therefore, unless challenged in a TEFRA proceeding, those partnership items, as reflected on a Form 1065 or a Schedule K-1, of the source partnership --- the one in which X's partnership interest is to be determined --- must be accepted in determining the basis of that partnership interest. See Roberts, supra; Treas. Reg. 301-6222(a)-2T(a).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



Our office is available to provide further assistance as you develop the facts in this case. Please call if you have any further questions.