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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL
ROCKY MOUNTAIN DISTRICT CC:WR:RMD:DEN

FROM: Curtis G. Wilson
Assistant Chief Counsel
(Administrative Provisions and Judicial Practice)
CC:PA:APJP

SUBJECT:
Partnership Items in valuing partners' partnership interests

This Field Service Advice responds to your memorandum dated May 3, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

DISCLOSURE STATEMENT

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LEGEND

P =

A =

B =

GROUP A the consolidated group for which A filed income tax returns
A1
A2

GROUP B the consolidated group for which a filed income tax returns
B1
B2

C =
D =
E =

YEAR 1
DATE 1
DATE 2
DATE 3

ISSUE

Whether the valuation of a partners' pro rata share of partnership assets transferred pursuant to section 367(a)(4) requires a determination of partnership items in an administrative proceeding under I.R.C. §§ 6221 through 6234.

CONCLUSION

We recommend that a partnership proceeding be instituted under I.R.C. § 6223 for the purposes of determining that value of the partnership assets that are being used, per elections under I.R.C § 1492(a)(2)(B) and Treas. Reg. §1.367(d)-1T(g)(2), to value the partnership interests that were transferred to entities outside the United States.

FACTS

P is a general partnership formed by A1, A2, B1, and B2 on DATE 1. A1 and A2 are corporations that file consolidated income tax returns with the consolidated group headed by A. B1 and B2 are corporations that file consolidated income tax returns which the consolidated group headed by B. Combining the subsidiaries' interests, the two consolidated groups each held equal -- 50% -- partnership interests in P.

In YEAR 1, on DATE 2, A1 and A2 transferred their partnership interest in P to C, a foreign partnership in exchange for a combined 100% interest in C. In a parallel transaction on the DATE 2, B1 and B2 transferred their partnership interest in P to D, another foreign partnership, in exchange for a combined 100% interest in D. On DATE 3, the next day, C and D each transferred their assets, including the newly acquired partnership interests in P, to E, a foreign corporation in exchange for 100% of the stock of E. C and D each held 50% of E's stock.

A1, A2, B1, and B2 (hereinafter collectively referred as "the taxpayers") each treated its transfer of its partnership interest in P to the foreign entities, C and D, as not being subject to excise tax under former I.R.C. § 1491, because they filed elections under I.R.C. § 1492(a)(2)(B). Each partner filed a Form 926, Return on a U.S. Transfer of Property to as Foreign Corporation, on which it made elections under I.R.C. § 1492(a)(2)(B) and Treas. Reg. §1.367(d)-1T(g)(2) to apply the principles of section 367 to the transfer of their partnership interests and to treat the outbound transfer of operating intangibles as a deemed sale. Thus, under I.R.C. § 367(a)(4), each transfer of a partnership interests is treated as a transfer of each partner's pro rate share of the assets of the partnership. The gain on the sale is subject to income tax. GROUP A and GROUP B each reported a gain from the transfers based upon a gross valuation of each partner's pro rata share of the assets of P, less the adjusted basis in those assets.

C and D similarly made deemed sales elections for treating their transfers of their interests in P to E on DATE 2.

P timely filed a Form 1065, U.S. Partnership Return of Income, for YEAR 1 on which it reported, in an attachment, that the taxpayers had contributed their partnership interest in P to C and D and that these contributions had caused a technical termination of P on DATE 1. P, which was not required to report the section 367 gain resulting from the partners' transfer of partnership interest in it, did not otherwise report the transaction on its Form 1065.

The IRS is auditing GROUP A and GROUP B for YEAR 1. In the course of those audits, the IRS has substantially completed its factual investigation of these transactions. It has made a preliminary decision concerning that the fair market value of the assets of P in order to establish the value of the partnership interests transferred by the taxpayers.

Before proposing adjustments to the consolidated income tax liabilities of GROUP A and GROUP B based upon these transactions, the Service has asked whether an administrative review of P should first be completed under the TEFRA partnership audit provisions. Both GROUP A and GROUP B have agreed to extend the time to assess tax on Forms 872.

LAW AND ANALYSIS

In 1982, Congress enacted the TEFRA unified audit and litigation procedures to substitute a simplified and streamlined entity-level partnership audit, litigation, and assessment process in lieu of instituting multiple separate proceedings with the partners. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 646 (1982); H.R. Rep. No. 97-248 at 600 (1982), 1982-2 C.B. 462. The TEFRA procedures provide rules for the examination of a partnership entity that parallel and supplement the existing rules and procedures in the Code for the examination of a taxpayer’s return.

The TEFRA procedural rules at I.R.C. §§ 6221 through 6234 supplement the general rules for making a tax assessment against an individual taxpayer by inserting the audit of a TEFRA entity into the examination process before an assessment of taxes can be made against a partner based upon a “partnership item.” Under TEFRA, the tax treatment of any partnership item can only be determined at the partnership level. I.R.C. § 6221. While nonpartnership items can be determined in notice of deficiency issued to individual taxpayers, section 6225(a) prohibits the assessment of a deficiency “attributable to a partnership item” before a notice of final administrative adjustment is mailed to the tax matters partner for the partnership. See Maxwell v. Commissioner, 87 T.C. 783 (1986), for a discussion of the dichotomy between the deficiency and partnership audit proceedings. If a partnership item is not raised in a partnership level proceeding, the parties are precluded from raising the partnership issue in any subsequent proceeding. Saso v. Commissioner, 93 T.C. 730 (1989). The prohibition in section 6225(a) is effective, unless a partner waives any rights and any restrictions upon the Service in a written agreement under section 6224. Thus, if the determination of the tax effect of the taxpayers’ transfer of their partnership interests outside the Untied States is “attributable to a partnership item,” it will be necessary to institute an administrative proceeding under the TEFRA provisions before proposing adjustments to the income of the taxpayers from the transfers.

A partnership item is defined in I.R.C. § 6231(a)(3):

> The term "partnership item" means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under Subtitle A [income tax provisions] to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

Treas. Reg. § 301.6231(a)(3)-(1) lists the items that are "required to be taken into account for the taxable year of a partnership" and that the Service considers to be "more appropriately determined at the partnership level." These items include:

> (1) The partnership aggregate and each partners' share of:
>
> > (i) Items of income, gain, loss, deduction, or credit of the partnership; [and]
> >
> > * * *
> >
> > (iv) Other items determinable at the partnership level with respect to partnership assets, investments, transactions and operations necessary to enable the partnership to determine [investment credits, the recapture of investment credits, amounts at risk, depletion allowances, and the application of section 751(a) and (b); [1] and]
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> * * *
>
> (3) Optional adjustments to the basis of partnership property pursuant to an election under section 754 (including necessary preliminary determinations, such as the determination of a transferee partner's basis in a partnership interest);"

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[1] Section 751(a) provides that the amount received by a partner on the sale or exchange of a partnership interest will include the amount received for unrealized receivables and inventory as the amount realized from the sale or exchange of property other than a capital asset.

Treas. Reg. § 301.6231(b) adds that the "term 'partnership item' also includes the accounting practices and the legal and factual determinations the underlie the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc."

The regulations do not specifically include the valuation of assets as a partnership item; in particular, they do not address the valuation of assets for purposes of reporting the gain or loss resulting from the transfer of partnership interest to a foreign entity. Valuing partnership assets, however, falls within the regulation's broad definition of "partnership items." The basis or value of partnership property is a partnership item. Maxwell v. Commissioner, 87 T.C. 783, 791. It is obviously necessary to value particular partnership assets to determine tax consequences, such as the deductions allowable to a partnership for depreciation or the character and amounts of property distributed to a partner. See Regents Park Partners v. Commissioner, T.C. Memo. 1992-336, 63 T.C.M. (CCH) 3131, 3132 (1992) (Tax Court valued real estate acquired by the partnership in a TEFRA proceeding); Treas. Reg. § 301.6231(a)(3)-1(a)(4). Likewise, the assets may need to be valued to determine the proper amount of the income, gain, or loss from the partnership's sale or exchange of such assets in any given partnership tax year. [2]

Because the taxpayers elected, under I.R.C. § 1492(a)(2)(B) and Treas. Reg. §1.367(d)-1T(g)(2), to apply the principles of section 367 to the transfer of their partnership interests and to treat the outbound transfer of operating intangibles as a deemed sale, the determination of their income tax liability on the transfer of their partnership interests is attributable to partnership items of their partnerships. By virtue of the elections, each partner's transfer of a partnership interest is treated, under I.R.C. § 367(a)(4), as a transfer of the partner's pro rate share of the assets of the partnership. To determine the gain on the sale of the partnership's assets, the assets themselves must be valued.

We recognize that the gain on the sale of a partnership interest, or the character of such gain, is not usually a partnership item. See Regents Park Partners v. Commissioner, T.C. Memo. 1992-336. In Regents Park, the Service determined, among other adjustments in a TEFRA partnership case, that a partner must treat any gain from the sale of his partnership interest that was attributable to excess

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[2] The gain on a sale or other disposition of property is defined in section 1001(a) as the amount realized over the adjusted basis while the amount by which the adjusted basis exceeds the amount realized is a loss. Section 1001(b) provides that the amount realized is the sum of money received plus the fair market value of the property received. Where, as in this case, the value of the assets being transferred between related parties is used to determine the value of the property being received in exchange, it is necessary to determine the value of such assets themselves.

depreciation as ordinary income. The Tax Court, relying upon dicta in Clovis I v. Commissioner, 88 T.C. 980-982 (1987), determined that it did not have jurisdiction over that characterization of the partner's income because the proposed adjustment did not, inter alia, "[result] in adjustments to the partnership income and return."

The critical question, however, is whether the items underlying the adjustment are items that a partnership is required to take into account on its books and records for the taxable year. See Dial USA, Inc. v. Commissioner, 95 T.C. 1 (1990) (a shareholder's basis is not a subchapter S item). However, to the extent that components of basis or amount at risk or other adjustments are more appropriately determined at the partnership level, they should be raised in TEFRA partnership level proceedings. See University Heights v. Commissioner, 97 T.C. 278 (1991) and Gemini Twin Fund III v. Commissioner, T.C. Memo. 1991-315, aff'd, 1993 U.S. App. LEXIS 27280 (9th Cir. 1993). If no partnership proceeding precedes a partner level proceeding, the parties will be bound by the reporting of the partnership items on the partnership return and the treatment of these items on the partnership books and records. Doe v. Commissioner, 97-1 U.S.T.C. ¶ 50,460, 80 A.F.T.R.2d 5535 (10th Cir. 1997); Roberts v. Commissioner, 94 T.C. 853 (1990). To avoid being bound by P's valuation of its assets in valuing the taxpayers' partnership interests, we recommend that you determine the value of the assets in a TEFRA audit of P.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

Please call if you have any further questions.