

Department
of the
Treasury

Internal
Revenue
Service

Office of
Chief Counsel

Notice

CC-2009-011

March 11, 2009

Subject: Protective Assessments of Affected Items in TEFRA Partnership Cases **Cancel Date:** Upon incorporation into the CCDM

Purpose

This Notice is provided to assist Chief Counsel attorneys in advising the Internal Revenue Service regarding protective assessment procedures in cases subject to the unified partnership audit and litigation procedures of I.R.C. §§ 6221-6234, when a partner has engaged in a transaction for which a loss reported on the partner's return is associated with the sale of a partnership interest or an asset distributed by the partnership.

Background

A TEFRA partnership audit comes with the inherent difficulty of determining which items are most appropriately determined at the partnership level and applying these partnership-level determinations to the individual partners' personal tax returns. Items can generally be classified as either partnership items or affected items and the classification determines whether a court has jurisdiction over a particular item in a particular proceeding and when and how assessments can be made. Hence, litigation hazards exist if an item is not properly classified.

A partnership item is any item required to be taken into account for the partnership's taxable year that is more appropriately determined at the partnership level rather than at the partner level. I.R.C. § 6231(a)(3). These items include, but are not limited to, (1) the partnership aggregate and each partner's share of items of income, gain, loss, deduction, or credit of the partnership; (2) the amount and type of any partnership liabilities; (3) optional adjustments to the basis of partnership property pursuant to a section 754 election; and (4) the amount of contributions to the partnership. Treas. Reg. § 301.6231(a)(3)-1. At the conclusion of an audit, the IRS will issue a notice of Final Partnership Administrative Adjustment with respect to the partnership's partnership items. I.R.C. § 6223.

Partnership items flow through and are reported in the computation of the taxable income of the partners. Adjustments to partnership items have an affect on the partners' tax return (e.g., Form 1040 or Form 1120) by causing adjustments to other line items, some of which are not related to the partnership (referred to as nonpartnership items). These nonpartnership items that are affected by the partnership adjustments are "affected items."

Distribute to: All Personnel
 Electronic Reading Room

Filename: CC-2009-011 File copy in: CC:FM:PF

There are two types of affected items: (1) those that only require a computation of the tax once the partnership proceeding is completed and (2) those that require partner-level determinations to be made once the partnership-level proceeding is completed. See Maxwell v. Commissioner, 87 T.C. 783 (1986); N.C.F. Energy Partners v. Commissioner, 89 T.C. 741, 744 (1987); Treas. Reg. 301.6231(a)(5)-1.

A computational affected item is an item on a partner's return that can be adjusted mathematically without the need for further factual determinations at the partner level. Treas. Reg. § 301.6231(a)(6)-1(a)(1). Computational affected items include those items on a partner's return that vary if there is a change in the individual partner's adjusted gross income. For example, an adjustment to a partnership item that results in a change to a partner's adjusted gross income will have a cascading effect, resulting in a change to the threshold dollar limit for the medical expense deduction permitted under section 213. The threshold limit for the medical expense deduction is an affected item for which no partner-level determination needs to be made to determine the new amount to be reported on the partner's return. These adjustments are purely mathematical and can be directly assessed at the conclusion of the partnership proceeding by applying the partnership adjustments to each of the partners. I.R.C. § 6230(a)(1); Treas. Reg. § 301.6231(a)(6)-1.

The second type of affected item is an adjustment that requires further determinations at the partner level before the adjustment can be made to the partner's return. For example, a partner's basis in the partnership interest is generally determined at the partner level, as are the limitation of deductions under the passive activity and at-risk rules. Because further determinations are required at the partner level, deficiency procedures apply to these affected items. I.R.C. § 6230(a)(2); Treas. Reg. § 301.6231(a)(6)-1(a)(3). The IRS has one year from the conclusion of the partnership proceeding to issue a notice of deficiency for the affected items. I.R.C. § 6229(d). Under section 6213(a), the partner has 90 days to petition the deficiency in Tax Court. Alternatively, the partner can pay the deficiency and file suit for refund under section 7422.

Penalties that relate to partnership items are affected items that may require further determinations at the partner level. Section 6230(a)(2)(A)(i), however, states that deficiency procedures shall not apply to penalties, additions to tax, or additional amounts that relate to adjustments to partnership items. This is because for partnership taxable years ending after August 5, 1997, the applicability of any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item is determined at the partnership level. I.R.C. § 6221. Consequently, penalties that relate to adjustments to partnership items can be directly assessed and collected at the conclusion of the partnership proceeding, regardless of whether any partner-level determinations may be required. Treas. Reg. § 6231(a)(6)-1(a)(3). Partners may raise partner-level defenses (those that are personal to the partner or that are dependent on the partner's separate return and cannot be determined at the partnership level) to a penalty only through a refund action after assessment and payment. Treas. Reg. § 301.6221-1(d); I.R.C. § 6230(c)(4). For example, penalties attributable to a disallowance of a partnership's deductions of short-term capital loss and interest expenses or an adjustment of any other partnership item, such as a determination that the partnership is a sham or that the partners' contributions are inflated, cannot be challenged in a deficiency proceeding. Therefore, penalties related to partnership-level adjustments should be directly assessed even if the deficiency that results from the partnership-level determinations is itself subject to affected item deficiency procedures. See Domulewicz v. Commissioner, 129 T.C. 11 (2007).

Application

The protective assessment procedures outlined below should be applied in those cases in which a partner has sold at a loss (or reduced gain) either the TEFRA partnership interest or an asset distributed by the TEFRA partnership. The partnership typically engages in a listed transaction or other transaction to generate a fictitious step up in the partner's basis in the sold asset. The partner's basis in the partnership interest or the distributed asset and the resulting loss is an affected item that requires further determinations at the partner level and, hence, a notice of deficiency. Thus, the Service must issue an affected item notice of deficiency disallowing the loss at the partner level following the partnership proceeding. Likewise, partner-level deductions related to expenses paid in connection with the purported partnership investment (e.g., legal fees) will also be affected items subject to the deficiency procedures.

Protective Assessment Procedures

If a partner has reported a loss (or reduced gain) on the partner's individual return as a result of having sold the TEFRA partnership interest or an asset distributed by the TEFRA partnership, the IRS should make certain protective assessments to ensure that the assessments are made before the period of limitations on assessment expires. Given the different types of affected items – those that can be directly assessed and those requiring determinations at the partner level – the IRS may not know with certainty how a court will classify the affected item. See, e.g., Countryside L.P. v. Commissioner, T.C. Memo. 2008-3, n. 4 (2008); Bedrosian v. Commissioner, T.C. Memo. 2007-376 (2007). The IRS generally has one year from the close of the period within which a petition may be filed with respect to an FPAA or, if a petition is filed, the date the decision of the court becomes final, to assess any deficiency resulting from the adjustments to the partnership items or to issue a notice of deficiency. If the IRS issues a notice of deficiency, the statute of limitations is tolled, but only if section 6230(a)(2) authorizes the notice of deficiency. See I.R.C. § 6503(a)(first parenthetical).

To account for this uncertainty in classifying affected items, the IRS should issue a notice of deficiency with respect to the affected items and any penalties relating to the affected items within eight months of the conclusion of the partnership-level proceeding. After the 90 days has expired for the partner to petition the Tax Court, the IRS should assess the entire deficiency, including any penalties, reflecting both the outcome of the partnership-level proceeding as well as what was included in the affected item notice of deficiency. The entire assessment of tax and penalties should be made within the one-year period for assessment. This assessment should be made regardless of whether the partner has filed a petition with the Tax Court to challenge the determination set out in the notice of deficiency. This assessment guards against a partner's argument that the affected item was directly assessable and not subject to the deficiency procedures and is, therefore, outside the period for assessment. The procedure also protects the government against any argument that penalties that relate to affected items that require partner-level determinations are not directly assessable. If the statutory notice is not petitioned, the assessment for both the tax and the penalties will be valid regardless of whether the deficiency procedures apply.

If a petition is filed in response to the affected item notice of deficiency and the partner then moves to enjoin the assessment of the tax and the penalties, Counsel attorneys should agree to abate the assessment related to the deficiency provided that the court agrees the loss (or decreased gain) reported on the partner's return is subject to the deficiency procedures. By making this finding, the court is agreeing that further determinations need to be made at the

