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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Thomas G. Schleier,
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CC:LM:CTM:SF

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

SUBJECT: Allocation of partnership items between divorced spouses

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LEGEND:

X =

Y =

Z =

LP =

YEAR 1 =
YEAR 2 =
YEAR 3 =
YEAR 4 =
YEAR 5 =
YEAR 6 =
YEAR 7 =
YEAR 8 =
YEAR 9 =
YEAR 10 =

DATE 1 =
DATE 2 =
DATE 3 =

ISSUES:

1) Is the allocation of partnership income and losses between a partner and his former spouse pursuant to a state court order concerning the post-divorce distribution of marital property in a community property regime a partnership item that must be raised in an FPAA?

2) May the Service, in order to disallow a partner's claimed carryback of partnership losses to the years before the Tax Court in the partner's deficiency proceeding for carryback years, contest the amount and validity of losses reported by the partnership in the loss year.

CONCLUSION:

1) The allocation of partnership income and losses between a partner and his former spouse pursuant to a state court order concerning the post-divorce distribution of marital property in a community property regime is not a partnership item and may be raised in a notice of deficiency.

2) The Service may disallow a partner's claimed carryback of partnership losses to the years before the Tax Court in the partner's deficiency proceeding for the carryback years based upon the partner's use of the losses reported by the partnership, but should, if possible, contest the amount and validity of losses reported by the partnership in an FPAA for the year in which the losses were reported.

FACTS:

In YEAR 1, during his marriage to Z, petitioner X formed a California limited partnership, LP, in which he became a general partner. Pursuant to the partnership

agreement, the partnership was required to distribute a percentage of any income allocated to a general partner's account during any year. Z was never identified as a partner in LP and never received a Schedule K-1 from LP.

X and Z resided in California, a community property state, throughout their marriage. X and Z separated in YEAR 2 and were divorced, pursuant to a judgment of dissolution, in YEAR 3. After the marriage was dissolved, the property settlement negotiations, including the valuation and disposition of X and Z's interest in LP, continued. X married Y during YEAR 4.

On DATE 1 in YEAR 8, a California court determined that the marital community had owned a percentage of the aggregate ownership of LP. The judgment, made effective as of DATE 2 during YEAR 3, retroactively awarded the partnership interest in LP to X. On DATE 3 in YEAR 9, the California court vacated the prior judgment and issued a new judgment awarding the partnership interest in LP to X as of DATE 3. The DATE 3 judgment, unlike the vacated DATE 1 judgment, did not operate retroactively.

LP issued Schedules K-1 to X for YEAR 4, YEAR 5, YEAR 6, and YEAR 7, the years at issue in this case, to reflect X's distributive share of various items of partnership income and losses. X and Y reported one-half of the income shown on the K-I from LP for YEAR 4 and YEAR 5, In an attached disclosure statement, X indicated that Z was responsible for the other half of the partnership items reported to him. Petitioner deposited the YEAR 4 and YEAR 5 cash distributions he received from the partnership into his bank accounts.

For YEAR 6 and YEAR 7, LP reported net partnership losses to X. X and Y reported all of the losses on their income tax returns for YEAR 6 and Year 7. X did not allocate any of the losses from LP to Z in YEAR 6 and YEAR 7. LP made no distributions to X in Year 6 or YEAR 7.

In YEAR 10, the Service issued a notice of deficiency to X and Y, from which they filed a timely petition with the Tax Court in this case with respect to the deficiencies determined by the Service for YEAR 4, YEAR 5, YEAR 6, and YEAR 7. [redacted] The Service has contested neither the amount of LP 's partnership income, losses, or other partnership items nor the allocation of any portion of such partnership items to X in his capacity as a general partner in LP. The Service is considering whether to determine a deficiency in X and Y's income tax liability YEAR 8 based upon the DATE 1 court order and whether to contest X's application of losses from LP in YEAR 8 as well as their carryback to the years now before the Tax Court.

LEGAL ANALYSIS

This advice is limited to a discussion of how the procedural rules in Chapter 63 of the Internal Revenue Code apply to the pending litigation and to any related tax adjustments that may be proposed.

ISSUE 1: The allocation of partnership income received by one spouse between spouses and former spouses is not a partnership item and is, therefore, properly within the Tax Court's jurisdiction in a deficiency case.

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 section 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 YEAR1 through YEAR 9, 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). The Service's 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 gains and losses 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. 193 (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 is 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 a 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 section 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 its 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 and Y's failure to report the full amount of the income allocated to X by LP for YEAR 4 and YEAR 5 and X's failure to allocate one-half of the losses allocated to X by LP for YEAR 6 and YEAR 7. The Service's determinations do not affect the amount of the income, losses, or other partnership items reported by LP for any of the years at issue, but is limited to the affected item of how such income and losses are to further allocable between X and Z under state community property laws and I.R.C. § 66(c). Further, if the Service were to determine that the court order issued on DATE A effected a change in the distribution of partnership income and losses between X and Z in YEAR 8 or required X to recover, in YEAR 8, the portion of his partnership income that had previously been allocated to Z, such determination would be an affected item in YEAR 8. As in Jenkins v. Commissioner and in Roberts v. Commissioner, that determination would properly be made in a notice of deficiency.

It might be argued that the allocation of X's share of the income or losses reported by LP between X and Z is a partnership item that must be addressed in a partnership level proceeding because Z is a partner in LP, as the term "partner" is defined in I.R.C. § 6231(a)(2). For purposes of Chapter 63, Subchapter C, "Tax Treatment of Partnership Items," that section defines a partner as "a partner in the partnership" or "any other person whose income tax liability under subtitled A [the income tax is determined in whole or in part by taking into account directly or indirectly items of a partnership." Thus, for purposes of applying the TEFRA procedural rules for partnership examinations and litigation, spouses and former spouses of the partners in a partnership are treated as partners. The section 6231(a)(2) definition of partner, however, does not extend the definition of "partner" for other Internal Revenue Code sections, such as I.R.C. § 704, "Partner's Distributive Share." For purposes of allocating income and losses among the partners in a partnership, the term "partner" is more limited: as defined in I.R.C. § 7701(a)(2), it includes any "member in . . . a syndicate, group, pool, joint venture, or organization" that is treated as a partnership for tax purposes. Although Z may

be entitled to participate in an examination of LP as partner, she is not a partner in LP for purposes of determining each partner's share of LP's income and losses in a partnership proceeding. The allocation of X's share of LP's partnership income and losses between X and his former spouse does not require the examination of LP's books and records and is more appropriate determined in a proceeding for the partner than at the partnership level. How X and Z allocate the income and losses reported to X by LP between themselves for any tax year has no impact on LP or X's partners in LP.

ISSUE 2: The Service may contest X's right to carry back the amount of any losses reported to X by LP for YEAR 8 to YEAR 4 and YEAR 5, but should not contest the validity of the losses as reported by LP except in a timely issued FPAA to LP for YEAR 8.

X has indicated that he may claim the carryback of his share of the LP losses reported in YEAR 8 to offset any tax deficiencies that are determined to be due from X and Y in this case for YEAR 4 and YEAR 5. Provided the issue is timely and properly raised, X and Y would be able to carryback any available portion of the losses that LP reported to X in YEAR 8 in the Tax Court case under Code § 6214(b), even though the later year is not before the court. In determining X and Y's tax liability, including overpayments, for YEAR 4 through YEAR 7, the court clearly 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 consistently held that the court 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 X could claim the carryback of additional losses from LP or whether the Service could question the validity of the losses reported by LP to X in YEAR 8 presents another issue. The questions of the amount of the losses actually incurred by LP in YEAR 6 and of X's share of those losses would involve not only the carryover of losses from tax years not before the court, but the redetermination of losses incurred and reported by the partnership. Under the TEFRA procedural rules, the losses reported on LP's partnership returns are partnership items that can only be redetermined in a TEFRA partnership. See sections 6221 through 6233. It is not clear whether the Tax Court's authority to consider facts with relation to the taxes for other years or calendar quarters under section 6214(b) extends to the consideration of partnership items.

The Tax Court previously had occasion to consider this issue in Durrett v. Commissioner, T.C. Memo. 1994-179, a deficiency case in which the taxpayer sought to amend the petition to raise the carryback of investment tax credits from an unaudited TEFRA partnership. Before exercising its discretion to deny the taxpayer's motion because it would result in undue prejudice to the Service, the court concluded that it had authority under section 6214(b) to consider adjustments partnership items if it allowed the taxpayer to amend the petition to raise the carryback of partnership items. Presumably, under the analysis in Durrett, if X and Y were permitted to amend their petition to raise the carryback of partnership losses in this case, the court could also consider adjustments to those partnership items.

In its opinion in Maxwell v. Commissioner, 87 T.C. 783, 789 (1986), however, the 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 VIMAS Ltd., a limited partnership in December 1982, with 13 limited partners and himself as the general partner. While a partnership audit of VIMAS 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 VIMAS' 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 VIMAS audit and had not issued an FPAA to the VIMAS 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 "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

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[1] None of the partnership items reported on the partnership returns filed by PS have been converted into nonpartnership items under section 6231: 1) the Service has not notified X that the items shall be treated as nonpartnership items; 2) X has not filed suit after the Service failed to allow an administrative adjustment request (since none was filed); 3) the Service has not entered into a settlement agreement with X; and 4) (because there have been no proceedings) the Service has not failed to provide timely notice of partnership proceedings to X.

> 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 cannot consider an adjustment to the character of the losses reported by a TEFRA partnership, a partnership item, until the Service issues an FPAA for the partnership. Further, the Tax Court may consider the partnership items only in a partnership proceeding, not in a deficiency proceeding, even if a 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 amount, the characterization, or the allocation of the losses reported by LP for YEAR 8, the Court's analysis in Maxwell would lead to the conclusion the Tax Court does not have jurisdiction to consider changing the character or the amount of such losses, or the allocation of those losses among the LP partners.

If the rationale in Maxwell was followed in this case, the court's jurisdiction under section 6214(b) would be limited to considering X and Y's use of the losses as reported by LP for YEAR 8. Like the carryback of losses and investment tax credits in Maxwell, the carryback of X's share of the LP losses to earlier years by X and Y would be an "affected item." See Bob Hamric Chevrolet, Inc. v. United States, 849 F. Supp. 500 (W.D. Tex 1994)(When a partnership loss, deduction or credit allocated to a partner in one year carries over or back to other years at the partner's level, such carryover or carryback is an affected item). Because changes to affected items need not be determined in a partnership proceeding, the Tax Court has jurisdiction under section 6214(b) to consider the amount of any passed through partnership losses that can be carried back or carried forward to the year before the court by considering the taxpayer-partner's use of the loss in the year before the court and in other years. See Harris v. Commissioner, 99 T.C. 121 (1992).

However, to the extent that the existence and amount of a net operating loss carryback or carryforward that is available in a given year rests upon the existence and amount of a partnership item, i.e., the loss reported by the partnership, the Tax Court cannot consider changes in the amount of the partnership loss. See Harris v. Commissioner, 99 T.C. 121 (1992), in which the Tax Court held that section

6214(b) gave it jurisdiction to consider NOL carrybacks based upon a settled TEFRA case in a Rule 155 computation, but that it would not take into account pending claims for NOLs in a second pending partnership case or hold the record open in the deficiency case until the pending partnership case was completed. The court agreed with the Service's stated conditions as to when section 6214(b) would apply:

> the settled partnership items may not be redetermined in the instant proceeding, . . . the NOL carryback claim must be consistent with the partnership settlement, and . . . the carryback claim must be made in the applicable limitations period for claiming refunds.

Harris, at 127. In other cases, the Tax Court has similarly held that it has no jurisdiction to redetermine any portion of a deficiency attributable to adjustments to partnership items when no FPAA has been issued by the Service. Trost v. Commissioner, 95 T.C. 560, 564 (1990); Roberts v. Commissioner, 94 T.C. 853, 859 (1990); Munro v. Commissioner, 92 T.C. 71, 73 (1989).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Please call if you have any further questions.