DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL

FROM: ASSOCIATE CHIEF COUNSEL
PASSTHROUGHS & SPECIAL INDUSTRIES
CC:PSI

SUBJECT: Optional Adjustments to Basis of Partnership Property

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LEGEND

A=
B=
C=

D=

State1=
State2=

Date 1=
Date 2=
Date 3=
Date 4=
Date 5=
Date 6=
Date 7=
Date 8=

$a=
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ISSUE

Whether the Service can bind A to its original representations regarding the amounts of basis step-ups resulting under section 743(b) from its acquisitions of partnership interests in B on Date 1, Date 2, and Date 3.

CONCLUSION

Under the duty of consistency, the Service can bind A to its original representations regarding the amounts of basis step-ups resulting under section 743(b) from its acquisitions of partnership interests in B on Date 1, Date 2, and Date 3. The Service relied upon A's original representations, and allowing A to change those representations after the expiration of the statute of limitations would be detrimental to the Service.

FACTS

1. Background

B was originally formed as C, a State1 general partnership, pursuant to a partnership agreement entered into on approximately Date 4. On Date 5, C converted into B, a State1 limited partnership.

On Date 6, B filed a voluntary petition under Chapter 11 of the Bankruptcy Code. B was reformed as a State2 limited partnership.

2. Acquisitions of Partnership Interests by A

On Date 1, A acquired a a% interest in B from D, the general partner of B. A paid $a for this partnership interest. The acquisition caused B to terminate under section 708(b)(1)(B) of the Internal Revenue Code. The resulting partnership elected to adjust the basis of partnership property under section 754.

On Date 2, A acquired an additional b% interest in B from c limited partners. A paid $b for these partnership interests. On Date 3, A acquired an additional d% interest in B from e limited partners. A paid $c for these partnership interests.

After these acquisitions, A owned a f% interest in B. g limited partners owned the remaining h% interest in B.

In each of the three acquisitions, the transferor partners' bases in their partnership interests equaled their share of basis in the partnership's assets. Thus in each acquisition, the gain (or loss) realized by the transferor partner under section 741 should equal the special basis adjustment to A under section 743(b). Under examination, A disputed the return positions taken by B and its partners, arguing that the transferor partners should have recognized increased gain on the sales and that A should have been entitled to increased basis adjustments. The statute of limitations had closed on the years in which the transferor partners sold their interests at the time of examination. This field service advice will analyze the three acquisitions first in the context of the positions taken by B on its returns, and second in the context of the positions taken by A under examination.

3. Return Positions Taken by B

A acquired a a% partnership interest in B from D on Date 1. A paid $a for this partnership interest. D's tax capital account at the time of the sale was $d. D thus realized a loss of $e on the sale. A claimed a special basis adjustment of $f on the purchase of its interest.[1]

In connection with the sale of D's partnership interest, B reported that D had forgiven partner loans to B totaling $g. B included $g in income from discharge of indebtedness. As a% partner, D was allocated $h of this income from discharge of indebtedness. D offset $i of this amount with a bad debt deduction on its corporate return.

A acquired an additional b% interest in B on Date 2 for $b. The transferor partners did not report any gain under section 741. A did not report a special basis adjustment in conjunction with the purchase.

A acquired an additional d% interest in B on Date 3 for $c. Again the transferor partners did not report any gain under section 741, and A did not report a special basis adjustment in conjunction with the purchase.

4. Positions Taken by A in Examination

On examination, A disputed the position taken in B's returns that the partner loans from D were cancelled in connection with the sale of D's partnership interest. A claimed that partnership liabilities to D in the amount of $j were assigned to A. If the liabilities were assigned, rather than cancelled, then D should have increased its basis in its partnership interest by $k, rather than by $h. Without this basis increase, D would have recognized gain of $l rather than a loss of $e on the sale of its partnership interest under section 741. Furthermore, A would be entitled to a positive basis adjustment of $l under section 743(b) rather than a negative basis adjustment of $e. Under section 6501, the statute of limitations with respect to D's Date 7 return has closed.

A acquired an additional b% interest in B on Date 2. On examination, A claimed that the selling partners had aggregate tax capital accounts totaling negative $m. Based on this figure, A claimed that it was entitled to a positive basis adjustment of $n under section 743(b) and that the selling partners should have recognized gain under section 741 of $n. Under section 6501, the statute of limitations with respect to the selling partners' Date 7 returns has closed.

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[1] A later explained that it overstated its basis adjustment due to a computational error. Using the figures provided on B's Date 7 return, A should have claimed a negative adjustment of $e.

A acquired an additional d% interest in B on Date 3. On examination, A claimed that the selling partners had aggregate tax capital accounts totaling negative $o. Based on this figure, A claimed that it was entitled to a positive basis adjustment of $p under section 743(b) and that the selling partners should have recognized gain under section 741 of $p. Under section 6501, the statute of limitations with respect to the selling partners' Date 8 returns has closed.

LAW AND ANALYSIS

You have asked whether the Service can bind A to its original representations regarding the amounts of basis step-ups resulting under section 743(b) of the Internal Revenue Code from its acquisitions of partnership interests in B on Date 1, Date 2, and Date 3. For the reasons discussed below, we agree with your conclusion that A is bound by its return positions because changing those positions after the expiration of the statute of limitations would be detrimental to the Service.

Section 61(a)(12) provides that gross income shall include income from discharge of indebtedness. Cancellation of indebtedness income occurring at the partnership level must be separately stated on Schedules K and K-1 in accordance with section 702(a)(7).

Section 743(a) provides that the basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership.

If the election under section 754 is in effect, then section 743(b) indicates that in the case of a transfer of a partnership interest by sale or exchange or upon the death of a partner, the partnership shall increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of its interest in the partnership over its proportionate share of the adjusted basis of the partnership property, or decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of its interest in the partnership. Section 743(c) indicates that the basis adjustment determined under section 743(b) shall be allocated in accordance with the rules provided in section 755.

The duty of consistency is an equitable doctrine that prevents a taxpayer from adopting a position for a particular year and, after the period of limitations for that year has expired, adopting a contrary position by claiming that the original treatment was incorrect to obtain a tax advantage in a later year. Estate of Ashman v. Commissioner, 231 F.3d 541 (5th Cir. 2000), *aff'g* T.C. Memo. 1998-145. Thus, for example, a taxpayer who benefitted from a representation in one tax year may not reduce his tax in a subsequent tax year by arguing, after the statute of limitations has expired on the earlier year, that the taxpayer's original representation was incorrect, and that more tax was due in the now-closed year. *See* Herrington v. Commissioner, 854 F.2d 755, 758 (5th Cir. 1988), *cert. denied*, 490 U.S. 1065 (1989); Estate of Letts v. Commissioner, 109 T.C. 290 (1997), *aff'd* 212 F.3d 600 (11th Cir. 2000). Thus, the duty of consistency prevents a taxpayer from obtaining a permanent exclusion of income that is taxable, or from deducting the same expense in multiple tax years.

The duty of consistency has three elements: (1) the taxpayer represents a fact or reports an item for federal income tax purposes for a particular year; (2) the Service acquiesces in or relies upon the representation of fact or the reported item for that year; and (3) the taxpayer attempts to change the representation or reporting in a subsequent year, after expiration of the period of limitation, and the change is detrimental to the Service. Herrington, 854 F.2d at 757.

A taxpayer's inclusion or omission of a particular item on a tax return can be a representation that the facts are consistent with how the item is reported. Thus, the failure to report a particular item of income may be an implied representation of the fact with respect to that item, which the taxpayer cannot repudiate at a later date.

When the duty of consistency applies, "the Commissioner may act as if the previous representation on which the Commissioner relied, continued to be true, even if it is not. The taxpayer is estopped to assert the contrary." Herrington, 854 F.2d at 758; Cleo Perfume, Inc. v. Commissioner, T.C. Memo. 1998-155.

The duty of consistency is based on the theory that a taxpayer owes the Service the duty to be consistent when a fact or transaction is projected in its tax consequences into another year and will not be permitted to benefit from the taxpayer's own prior error or omission. The court in Orange Securities Corp. v Commissioner, 131 F.2d 662, 663 (5th Cir. 1942), *aff'g* 45 B.T.A. 24 (1941), discussed the theory underlying the duty of consistency doctrine:

> While it is true that income taxes are intended to be settled and paid annually each year standing to itself, and that omissions, mistakes and frauds are generally to be rectified as of the year they occurred, this and other courts have recognized that a taxpayer may not, after taking a position in one year to his advantage and after correction for that year is barred, shift to a contrary position touching the same fact or transaction. When such a fact or transaction is projected in its tax consequences into another year there is a duty of consistency on both the taxpayer and the Commissioner with regard to it.

Similarly, in Alamo Nat'l Bank v. Commissioner, 95 F.2d 622, 623 (5th Cir. 1938), *cert. denied*, 304 U.S. 577 (1938), the court stated that "in income taxation what is done in one tax year is sometimes projected into another where the same fact must govern. There being continuity, there ought to be consistency in treatment."

First element

The first element of the duty of consistency is that the taxpayer must have made a representation or reported an item for tax purposes. Herrington, 854 F.2d at 758. For purposes of the duty of consistency, a taxpayer's treatment of an item on a return can be a representation of the facts that are consistent with the manner in which the taxpayer reports the item on the return. Estate of Letts, 109 T.C. at 299. For example, a failure to report income may be an implied statement of the facts relating to the taxpayer's receipt of funds, which, under the duty of consistency, a taxpayer cannot later repudiate. *See* Wentworth v. Commissioner, 244 F.2d 874, 875 (9th Cir. 1957), *aff'g.* 25 T.C. 1210 (1956) (failing to report the receipt of funds on an income tax return was a representation that the funds were a loan repayment); Portland Oil Co. v. Commissioner, 109 F.2d 479, 485-486 (1st Cir. 1940), *aff'g.* 38 B.T.A. 757 (1938) (failing to report a sale in 1929 was a representation that the sale did not occur in 1929).

A made representations on its returns for each of the three acquisitions of partnership interests regarding the amount of A's basis adjustment under section 743(b). A also made implied representations as to the Date 1 acquisition as it did not object to the inclusion by   of $j income from discharged debt. Thus, the first element of the duty of consistency is present in this case.

Second element

The second element of the duty of consistency is that the Commissioner must have relied on the taxpayer's representation. This element is present if the Commissioner accepts the taxpayer's income tax return and permits the statute of limitations to expire for that year. Herrington, 854 F.2d at 758. However, if the Commissioner knew or had reason to know prior to the expiration of the statute of limitations that a taxpayer had made a representation that was incorrect and failed to correct that representation before the expiration of the statute of limitations, then the duty of consistency does not apply. Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82, 91 (1971), *aff'd per curiam*, 456 F.2d 622 (5th Cir. 1972); Erickson v. Commissioner, T.C. Memo. 1991-97; Gmelin v. Commissioner, T.C. Memo. 1988-338, *aff'd without published opinion*, 891 F.2d 280 (3d Cir. 1989). To avoid the second element, a taxpayer must provide the Service with sufficient facts such that the Service has actual or constructive knowledge of a possible mistake in the reporting of the erroneously disclosed item. The Service may rely on a presumption of correctness of a return or report that is furnished under penalties of perjury, absent sufficient facts to supply the Service with actual or constructive knowledge to the contrary. Hughes & Luce, L.L.P. v. Commissioner, T.C. Memo. 1994-559, *aff'd*, 70 F.3d 16 (5th Cir. 1995). As stated by the Court of Appeals for the First Circuit, the duty of consistency requires that the taxpayer's misrepresentation "must be one on which the government reasonably relied, in the sense that it neither knew, nor ought to have known, the true nature of the transaction mischaracterized by the taxpayer." Lewis v. Commissioner, 18 F.3d 20, 26 (1st Cir. 1994).

It appears that the second element is present in this case. It does not appear that any information came to light with respect to the income tax returns of A or B for the closed years that would have caused the Service to know or have reason to know prior to the expiration of the statute of limitations for the closed years that A disputed the amount of its basis adjustment under section 743(b) such that the Service should have adjusted the income tax liability of A, B, or any transferor partners in the closed years to reflect such errors. By accepting the income tax returns of A and B for the closed years as filed with regard to the basis adjustment under section 743(b), and by allowing the statute of limitations to expire concerning this issue, the Service relied upon the implied representation in income tax returns of A and B for the closed years that the basis adjustments were properly calculated and that inclusion of income for discharged debt was proper.

Third element

The third element of the duty of consistency is that the taxpayer must have attempted to change the previous representation after the expiration of the statute of limitations. Herrington, 854 F.2d at 758; Beltzer v. United States, 495 F.2d 211, 212 (8th Cir. 1974). The third element is present in this case. Now that the statute of limitations has expired with respect to the assessment and collection of income tax for the closed years, and contrary to its prior representations as to its basis adjustments under section 743(b) for acquisitions in those years, A contends that its basis adjustment was computed inaccurately due to improper inclusion of income from cancelled debt and incorrect calculation of the transferor partners' tax capital accounts.

Conclusion

Because all of the elements of the duty of consistency have been satisfied, the Service may bind A and B to its original representations regarding the amount of A's basis adjustments under section 743(b). Accordingly, A cannot now claim, after the statute of limitations for assessment and collection of income tax has run for the closed years, that its basis adjustment was inaccurately calculated and should be increased for use in open years.

Finally, the duty of consistency is an affirmative defense upon which the Service bears the burden of proof and must be raised in the pleadings. *See, e.g.,* Lefever v. Commissioner, 100 F.3d 778, 784 (10th Cir. 1996), *aff'g* 103 T.C. 525 (1994); Unum Life Insurance Company of America v. United States, 886 F.Supp. 150 (D. Maine 1995). Accordingly, we suggest that the duty of consistency and facts necessary to support its application be developed as early as possible. For this reason we suggest that the Service notify the A of our intention to raise the duty of consistency as early as possible such as in a statutory notice of deficiency for the open years.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Please call (202) 622-3050 if you have any further questions.

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