DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Consistent Settlement

This Field Service Advice responds to your memorandum dated January 27, 1999. 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.

ISSUE(S)

1. Whether a settlement that disallows partnership losses and allows a theft loss to the partners in the amount invested in the partnership is subject to consistent settlement pursuant to I.R.C. § 6224(c).

2. Whether spouses who signed and filed a joint return are required to jointly execute a settlement agreement.

3. Whether the failure to allow a spouse to settle separately violates a taxpayer’s right to consistent settlement pursuant to I.R.C. § 6224(c).

CONCLUSIONS

1. A settlement that disallows partnership losses and allows a theft loss for the amount invested in the partnership may be subject to consistent settlement pursuant to I.R.C. § 6224(c) depending upon the structure of the settlement;

but if it is subject to consistent settlement rights, the right to consistent settlement would only arise with regard to that part of the settlement that relates to partnership items.

2. Spouses who signed and filed a joint return may be requested to jointly execute a settlement agreement, but there is no legal requirement to do so.

3. The failure to allow a spouse to settle separately does not violate a taxpayer's right to consistent settlement pursuant to I.R.C. § 6224(c) if the requirement of joint signatures was a requirement of the source agreement.

FACTS

This request relates to the general procedures for entering into settlement agreements in several tax shelters; accordingly, this is not based upon a specific set of facts, but rather is based upon common situations faced when settling large tax shelter projects. Thus, the analysis contained herein has broad general application, but its application to a specific set of facts is dictated by the facts that would be presented in each case. The general situation presented is that the Service intends to propose a settlement in which all partnership losses would be disallowed. The investors would be allowed a theft loss deduction to the extent of the amount invested in the partnership (less any losses allowed to date).

As a related issue, questions have arisen with regard to settlements with married persons who filed joint returns for the years at issue. Because the examination of tax shelters often requires a significant amount of time, many people who filed joint returns in the years at issue are no longer married, and thus it may be difficult for some to obtain the signature of their former spouse on a settlement agreement.

LAW AND ANALYSIS

With regard to settlements, the Code generally allows the Service to enter into written closing agreements with taxpayers "in respect of any internal revenue tax for any taxable period." I.R.C. § 7121. The TEFRA provisions provide for special rules in the case of settlements with regard to partnership items. See I.R.C. § 6224(c); see also Segel v. United States, 97-1 USTC ¶ 50,404 (S.D. Fla. 1997). Specifically, I.R.C. § 6224(c) addresses three specific issues:

- the binding effect on indirect partners of an agreement executed by a flow through partner (I.R.C. § 6224(c)(1));
- the right of partners to request an agreement that is consistent with an agreement that another partner has executed (I.R.C. § 6224(c)(2)); and

- the authority of a tax matters partner (TMP) to execute an agreement binding nonnotice partners (I.R.C. § 6224(c)(3)).

These provisions are exceptions to the general requirements of I.R.C. § 7121; specifically, that written agreement "with any person" only relates "to the liability of such person." Except as otherwise provided by I.R.C. § 6224(c), this general rule remains true in TEFRA cases, as observed in the legislative history: "No partner other than the TMP (and other than a pass-through partner with respect to indirect partners) may bind any other partner with respect to a settlement agreement." Conf. Rep. No. 97-248 at 602-603 (1982). Absent the statutory exceptions to I.R.C. § 7121 as set forth in I.R.C. § 6224(c), indirect partners and tax matters partners could not bind other partners to an agreement.

Similarly, absent the specific right to consistent settlement set forth in I.R.C. § 6224(c), partners in the same partnership would have no right to enter into an agreement that is consistent with that of another partner. See David v. Commissioner, T.C. Memo. 1993-621 n. 2 and accompanying text. Accordingly, Congress, by enacting I.R.C. § 6224(c)(2), created an exception to the general rules regarding settlement and created a right of consistent settlement in favor of partners in a TEFRA partnership.

Consistent Agreements

I.R.C. § 6224(c)(2) provides:

> (2) OTHER PARTNERS HAVE RIGHT TO ENTER INTO CONSISTENT AGREEMENTS.--If the Secretary enters into a settlement agreement with any partner with respect to partnership items for any partnership taxable year, the Secretary shall offer to any other partner who so requests settlement terms for the partnership taxable year which are consistent with those contained in such settlement agreement. Except in the case of an election under paragraph (2) or (3) of section 6223(e) to have a settlement agreement described in this paragraph apply, this paragraph shall apply with respect to a settlement agreement entered into with a partner before notice of a final partnership administrative adjustment is mailed to the tax matters partner only if such other partner makes the request before the expiration of 150 days after the day on which such notice is mailed to the tax matters partner.[1]

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[1]Note that, with regard to the timing of the source agreement and the request for consistent agreement, the Service, by regulation, has granted a broader right of consistent settlement. Specifically, Temp. Treas. Reg. § 301.6231(c)-3T(c)(3)(ii) allows consistent agreement within 60 days of the source agreement without regard to whether the source agreement was executed after the issuance of the notice of final partnership

Without regard to the regulations promulgated under this provision, the statute alone sets forth several requirements that must be met before the Service is required to execute a consistent agreement. The first clause of this rule states:

> If the Secretary enters into a settlement agreement with any partner with respect to partnership items for any partnership taxable year...

First, there must be a binding agreement between the Secretary and any partner - referred to herein as the source agreement -- and the source agreement must be an agreement with respect to partnership items. This requirement that the agreement relate to partnership items is reinforced by regulation, which states:

> Consistent settlement terms are those based on the same determinations with respect to partnership items. However, consistent settlement terms also may include partnership level determinations of any penalty, addition to tax, or additional amount that relates to partnership items. Settlements with respect to partnership items shall be self-contained; thus, a concession by one party with respect to a partnership item may not be based upon a concession by another party with respect to any item that is not a partnership item other than any penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item.

Temp. Treas. Reg. § 301.6231(c)-3T(b)(1) (January 26, 1999). The regulation clarifies that a source agreement "with respect to partnership items" must be limited to partnership items. Thus, an agreement that includes both partnership items and nonpartnership items does not give rise to a consistent settlement right. See Greenberg Brothers Partnership #4 v. Commissioner, 111 T.C. 198 (1998). As noted by the Tax Court in Greenberg Brothers, the consistent settlement regulation is a legislative regulation and thus is accorded "the highest level of judicial deference." Thus, as required by the statute as well as the regulation promulgated thereunder, the source agreement must be an agreement with regard to partnership items and only partnership items.

A similar requirement is imposed upon the consistent agreement. Beginning again with the statute, a consistent agreement must be allowed for

> ... settlement terms for the partnership taxable year which are consistent with those contained in such settlement agreement.

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administrative adjustment.

Accordingly, if the source agreement must be limited to partnership items, and the consistent agreement must be consistent therewith, then, *a fortiori*, the consistent agreement must also be limited to partnership items. As with the source agreement, the legislative regulations promulgated under this provision clarify this provision.

> Consistent agreements, whether comprehensive or partial, must be identical to the original settlement (that is, the settlement upon which the offered settlement terms are based). A consistent agreement must mirror the original settlement and may not be limited to selected items from the original settlement. Once a partner has settled a partnership item, or penalty, addition to tax, or additional amount that relates to an adjustment to a partnership item, that partner may not subsequently request settlement terms consistent with a settlement that contains the previously settled item.

Temp. Treas. Reg. § 301.6231(c)-3T(b)(1) (January 26, 1999). The regulation encompasses a number of scenarios, all intended to demonstrate the same principle - consistent settlement only applies to the same partnership items of partners in the same partnership for the same taxable year.

For example, if a partner enters into a settlement agreement, and later determines that another settlement agreement may have been more favorable, the partner may not request an agreement that is consistent with the later (more favorable) settlement. This result occurs because the partner is not seeking a settlement of partnership items. By virtue of having entered into the prior settlement, the partner's partnership items converted to nonpartnership items pursuant to I.R.C. § 6231(b)(1)(c). Thus, at the time of requesting a consistent agreement, the partner who had previously settled no longer had partnership items for which consistent treatment could be sought. See Slovacek v. United States, 98-1 USTC ¶ 50,397 (Fed. Cl. 1998).

This regulation also prohibits the bifurcation of settlement agreements. Stated simply, a partner cannot request consistent settlement only as to specific partnership items. This concept that the agreement must relate to the same partnership items is premised upon the concept that a settlement agreement may contain concessions by both parties, resulting in the final agreement. Thus, another partner should not be entitled to select those elements of a settlement that are most favorable without also being bound to the other components of the settlement. See Greenberg Brothers Partnership #4 v. Commissioner, 111 T.C. 198 (1998).

As a result of the requirement that the source agreement and the consistent agreement relate to the same partnership items, the agreements must also relate to the same taxable years. Again, this requirement is expressly set forth in the statute and amplified by regulation. The statute provides that a settlement of "partnership items for any partnership taxable year" gives rise to settlement rights for "the partnership taxable year." It is a fundamental concept of tax law that each taxable period is viewed independently. Commissioner v. Sunnen, 333 U.S. 591, 598 (1948) ("Income taxes are levied on an annual basis. Each year is the origin of a new liability and of a separate cause of action.") Thus, if partnership items relate to different taxable years, they are not the same partnership items and not subject to consistent settlement.

Lastly, the requirement that the partnership items be the same for the source agreement and the consistent agreement results in the inescapable conclusion that the items must stem from the same partnership. For example, in the tax shelter context, a tax shelter promotor may create a number of substantially identical partnerships. A settlement agreement executed by a partner in one of the shelters does not give rise to a consistent settlement right to a partner in a substantially similar, yet not the same, partnership. See Boyd v. Commissioner, T.C. Memo. 1992-626.

The specific question posed is whether a settlement that disallows partnership losses and allows a theft loss to the partners in the amount invested in the partnership is subject to consistent settlement pursuant to I.R.C. § 6224(c). There are two methods by which this settlement could be achieved. First, a single settlement agreement in which the partnership loss is disallowed and the theft loss is allowed could be executed. This type of agreement does not give rise to a right of consistent settlement because it is not self-contained and is not limited to partnership items. See Greenberg Brothers Partnership #4 v. Commissioner, 111 T.C. 198 (1998). It should also be noted that the use of a single agreement to cover both partnership and nonpartnership items is generally disfavored because it tends to frustrate the intent of the consistent settlement rule.

The second method by which the same result could be obtained would be to execute two separate settlement agreements: an agreement disallowing the partnership loss; and a separate agreement allowing the theft loss. The agreement disallowing the partnership loss would be an agreement as to partnership items and would be set forth on either a Form 870-P(AD) or the top half of Form 870-L(AD). Note that the top half of the Form 870-L(AD) requires separate execution by the parties and is deemed to be a separate settlement agreement. This agreement as to partnership items would be subject to consistent settlement. See Greenberg Brothers Partnership #4 v. Commissioner, 111 T.C. 198 n.14 (1998).

Conversely, the theft loss agreement would not be subject to consistent settlement. The theft loss agreement could be executed using either a Form 906 or the bottom half of a Form 870-L(AD). This agreement would be an agreement as to an affected nonpartnership item.[2] Though the amount of the loss will be determined by taking into account partnership items, the ultimate determination as to whether the partner is entitled to take the theft loss will be based upon the determination that there has been a theft from the partner. To be entitled to a theft loss, investors must demonstrate that they entered into a transaction only after having been deceived as to its nature. Bukove v. Commissioner, T.C. Memo 1991-76 (relying on California law). Because the allowance of the theft loss would be premised, as determined on a case by case basis, upon each partner's knowledge of the nature of the transactions at issue, the theft loss cannot be a partnership item. Because the theft loss is based in part on nonpartnership items, it is not subject to consistent settlement.[3]

Joint Filers

Unique issues arise in the context of the TEFRA provisions when applied to persons who file a joint return. Regardless of which spouse owned an interest in the partnership for the year at issue, for TEFRA purposes, both spouses are deemed to be partners. Temp. Treas. Reg. § 301.3261(a)(2)-1T(a)(1). For purposes of applying the unified audit and litigation procedures, I.R.C. § 6231(a)(2) provides a two part definition of "partner." First, a partner is a partner in the partnership. I.R.C. § 6231(a)(2)(A). Though circular, this definition essentially relies on the common law or state law definition of partner. However, for TEFRA purposes, the term "partner" also includes any other person whose income tax liability is determined by taking into account partnership items. I.R.C. § 6231(a)(2)(B). A person who does not own a partnership interest who files a joint return with a person who owns a partnership interest is deemed to be a partner under this provision. Pursuant to I.R.C. § 6013(d)(3), the liability for the tax reported on a joint return is joint and several. Thus, even if a spouse does not own an interest in the partnership, if partnership items are reported on a return, the spouse's tax liability is impacted by taking into account partnership items. As a result, the spouse is deemed a partner under I.R.C. § 6231(a)(2)(B).

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[2]By definition, any item that is not a partnership item is a nonpartnership item. I.R.C. § 6231(a)(4). Thus, an affected item is a nonpartnership item that is affected by partnership items. I.R.C. § 6231(a)(5). An element used in determining the amount of the theft loss would be based upon the amount the partner contributed to the partnership. Contributions to a partnership generally are partnership items. Treas. Reg. § 301.6231(a)(3)-1(a)(4)(i). Thus, it would be appropriate to treat the theft loss as an affected item.

[3]Furthermore, because one of the elements is whether the partner was deceived, insiders in the transactions at issue would not be able to demonstrate the necessary elements to qualify for relief under the proposed settlement.

Though both spouses are deemed to be partners, the Service has, in the past, taken the position that married persons who own (or are deemed to own) a joint interest are treated as one partner. See Dubin v. Commissioner, 99 T.C. 325, 330 (1992). However, in Dubin, the Tax Court concluded that, except in limited circumstances, spouses "are treated as separate persons." Id., 99 T.C. at 333. When applying this rationale in Dubin, the Tax Court concluded that if one spouse files for bankruptcy, it causes a conversion of partnership items only for that spouse. Similarly, a settlement of partnership items causes a conversion of partnership items of the partner who enters into the settlement. I.R.C. § 6231(b)(1)(C). Consistent with the court's rationale in Dubin, we conclude that interests held by spouses may be similarly bifurcated through settlement, and that spouses who report partnership items on a joint return may enter into separate settlement agreements.

We note, however, that the current instructions for signing a Form 870-P (for example) state as follows:

> If a joint return of a husband and wife was filed, both spouses must sign, unless one spouse, acting under a power of attorney, signs as agent for the other.

We believe that this requirement is properly interpreted to mean that both spouses signatures are required in order to settle both spouses liability. Conversely, it is unnecessary to obtain both spouses' signatures in order to settle one spouse's liability. If, under the rationale espoused in Dubin, each spouse is deemed to be a separate partner, then each partner should be permitted to settle separately. Nonetheless "the Service has the discretion to decide whether, and under what conditions, a closing agreement is executed." Michael I. Saltzman, IRS Practice & Procedure ¶ 9.09 at 9-63 (2d ed. 1991). General contract law principles govern the settlement of tax cases. Treaty Pines Investments Partnership v. Commissioner, 967 F.2d 206, 211 (5th Cir. 1992). It is a hallmark of contract law that an offer and an acceptance must express mutual assent, and that the acceptance must comply with the terms of the offer. Restatement (Second) of Contracts § 58. Thus, we believe that requesting dual signatures would be a permissible condition to place on a settlement, but that the rationale of Dubin makes such a requirement unnecessary.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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If you have any further questions, please call (202) 622-7950.