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CHIEF COUNSEL

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

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER CC:DOM:FS
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)

SUBJECT:

This Field Service Advice responds to your memorandum dated January 11, 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.

LEGEND:

A =
B =
C =
D =
E =
F =
G =
H =

Industry =

Country M =
Country N =

Region =

Year 1 =
Year 2 =
Year 3 =

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

Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
Amount 6 =
Amount 7 =
Amount 8 =
Amount 9 =

X =
Y =

Lender 1 =
Lender 2 =

Business Purpose =

ISSUES:

1. Whether interest income of a foreign partnership with United States partners is a partnership item subject to the TEFRA unified audit and litigation procedures.

2. If issue one is answered in the affirmative, whether the statute of limitations remains open for making adjustments to the partnership items of the foreign partnership.

CONCLUSIONS

1. For the taxable years at issue, interest income of a foreign partnership with United States partners is a partnership item subject to the TEFRA unified audit and litigation procedures.

2. The statute of limitations bars the making of adjustments to the partnership items of the foreign partnership described below.

FACTS

A is a United States corporation that is wholly-owned by B. B is a United States company engaged Industry. B is a wholly-owned subsidiary of C, a United States corporation which acquired the stock of B on Date 1 in a leveraged buyout.

C is a holding company for the stock of various foreign affiliates of B, including D, a Country M corporation which serves as the central business operation for the Region market. In Year 1, D acquired the stock of E from C. E is a Country N corporation engaged in the business operation in Country N. D was originally incorporated by C in Year 2 and E was incorporated in Year 3.

On Date 2, C incorporated two U.S. subsidiaries, F and G. On Date 3, it capitalized them with capital contributions of Amount 1 and Amount 2, respectively. On Date 4, F and G entered into a partnership agreement for the stated purposes of Business Purpose. Under the agreement, F was to contribute Amount 3 and G was to contribute Amount 4 to the Country N partnership called H.[1] In reality, on Date 3, F contributed Amount 1 and G contributed Amount 2 to the partnership. Converted at a rate of Amount 5 to the dollar, these amounts translate into dollars as Amount 1

[1] It is unclear why only F's name and not also G's name was incorporated into the partnership name, but the partnership is indeed ostensibly a combination of both entities.

and Amount 2, respectively. According to a Date 5 memorandum from A to the IRS agent, the driving force behind F's formation was to repatriate B assets in Country N that were subject to an immediate risk of devaluation in Country N.

On Date 6, the partnership entered into an agreement with D to acquire Amount 6 shares of the Amount 7 outstanding shares of E for Amount 8, equivalent in Country N currency to Amount 9. The agreement required that the Amount 8 purchase price be remitted within X days.

On Date 7, the partnership borrowed approximately Amount 8 worth of Country N currency in two loans received from the Lender 1. These funds were used to purchase approximately Y% of E from D. The loan documents indicate that the loans were to be secured by accounts receivable of E and were also guaranteed by two individuals.[2] In addition, the loan was guaranteed by B. The loans were repeatedly renewed along with the interest accrued to the date of renewal; at first with Lender 1, later with affiliates of Lender 2, and, lastly, with E. During the period at issue, the Country N currency was hyper-inflationary, and the loans were generally inflation adjusted through such methods as stating the principal in Country N treasury bonds or building in an inflation factor to be applied to the principal based on fluctuations in the value of the Country N treasury bonds.

The partnership filed partnership returns for its 52/53 week fiscal year ended Date 8 and for all subsequent tax years. On these returns, it reported substantial losses described as “Ordinary income (loss) from trade or business activities” (Line 1 of Form 1065, Schedule K-1) and distributed them to F and G in a proportion to their respective investments. These losses consist almost entirely of “interest expense” on the above loans. This “interest” is, in fact, largely foreign currency losses because it includes the increases in principal due to the inflation adjustments. The corresponding foreign currency gains, which arguably should have been realized and recognized when the loans were renewed, were omitted from the income statement portions of the returns apparently on the theory that they were, somehow, “unrealized gains.” They were added to the partners’ capital accounts as “nontaxable income” (Form 1065, Schedule M, column (d)). F and G claimed the losses in full, as part of the consolidated returns filed by C. The partners asserted that they had adequate adjusted basis in the partnership to do so under the theory of PLT 7410219830A to the effect that each loan renewal should

[2]Although not relevant for the arguments addressed herein, it is of concern for other arguments which we are considering raising that these two individuals are employees of E. Although nominally employees also of F, it appears that they were not paid by F or the partnership.

be converted to U.S. currency at the rate in effect on the renewal date and not the rate in effect at the partnership's year end.

LAW AND ANALYSIS

In 1982, Congress enacted the TEFRA unified audit and litigation procedures to simplify and streamline the partnership audit, litigation, and assessment process. The underlying principle of TEFRA is that "the tax treatment of items of partnership income, loss, deductions, and credits will be determined at the partnership level in a unified partnership proceeding rather than separate proceedings with the partners." Conf. Rep. No. 97-248 at 600 (1982). One of the specific goals of TEFRA was to reach foreign partnerships that distributed items of income, gain, and loss to domestic partners. Conf. Rep. No. 97-248 at 599 (1982).

Requirement of a Partnership Return

Section 6031(a) sets forth two general criteria under which a partnership must file a return. First, a partnership must set forth the items of gross income and the deductions allowable under Subtitle A. A foreign partnership with no income derived in or effectively connected with the United States has no items of income or deductions that are required to be reported under Subtitle A, and as a result, the filing requirement would appear to be inapplicable. However, I.R.C. § 6031 continues, and requires a partnership to report "such other information for the purpose of carrying out the provisions of Subtitle A as the Secretary may by forms and regulations prescribe." Accordingly, while the first portion of the return filing requirement is inapplicable to a foreign partnership, the second test allows the Secretary to require a return of a foreign partnership when it would aid in carrying out the provisions of Subtitle A. One such situation could be when a foreign partnership has a domestic partner that is reporting items that flow from the foreign partnership.[3]

The Treasury Regulations in effect at that time TEFRA was enacted and at the time the returns at issue were filed expressly addressed the foreign partnership return filing requirement, and state:

> A partnership carrying on no business in the United States and deriving no income from sources within the United States need not file a partnership return. (Treas. Reg. § 301.6031-1(d)(1).)

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[3] The Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 788, 980, added I.R.C. § 6031(e), which states that foreign partnerships are not required to file a return unless the partnership has gross income that is either derived from sources within the United States or effectively connected with a United States trade or business; however, this provision is only effective for tax years beginning after August 5, 1997.

The regulation clearly obviated the need for a foreign partnership to file a partnership return if its sources of income met the test set forth in the regulation. However, section 404 of the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, 96 Stat. 646 (1982) states:

> Except as hereafter provided in regulations prescribed by the Secretary of the Treasury or his delegate, nothing in section 6031 of the Internal Revenue Code of 1954 shall be treated as excluding any partnership from the filing requirements of such section for any taxable year if the income tax liability under subtitle A of such Code of any United States person is determined in whole or in part by taking into account (directly or indirectly) partnership items of such partnership for such taxable year.

Congress' intent for this provision is clarified by the Conference Report, which states that "[t]he bill explicitly applies the partnership return filing requirement under section 6031 to any partnership which has U.S. partners (direct or indirect)." Conf. Rep. No. 97-248 at 611 (1982).

It is clear that Congress intended to override the regulation as it existed when TEFRA was passed by requiring that a partnership return be filed by a foreign partnership if the foreign partnership has United States partners whose income tax liability is impacted by the distributive share of the foreign partnership's items. Congress' express language, both in the statute and in the committee report, indicate that the return filing requirement can only be waived by a subsequent regulation; however, neither temporary nor final regulations have been promulgated to address this issue.

In 1986, proposed regulations under I.R.C. § 6031 were introduced, in part, to address this issue. The proposed regulations retained the general rule that a foreign partnership with no United States income or United States trade or business is not required to file a partnership return; however, the regulations also set forth an exception for foreign partnerships with items allocable to United States partners. The proposed regulation stated:

> [A] foreign partnership shall file a partnership return for a partnership taxable year if at any time during that year an aggregate of 25 percent or more of any item of income, gain, loss, deduction, or credit of the partnership is allocable to a United States person or persons.[4]

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[4]The proposed regulations also contain special rules for indirect partners, which are inapplicable in the present matter.

Prop. Treas. Reg. § 1.6031-1(d)(2).

The preamble to the regulations noted that they were drafted in response to section 404 of TEFRA, and also stated that section 404 nullified the foreign partnership exception to the return filing requirement. The proposed regulations, if finalized as originally drafted, would have been retroactively effective to the date of the original enactment of TEFRA; however, the preamble expressly stated:

> A partnership that would be exempt from the filing requirement under the existing regulations, however, will not be required to file a partnership return for any partnership taxable year ending on or before the 90th day after the date on which a Treasury decision on the subject appears in the FEDERAL REGISTER.

Notice LR-198-82, 1986-1 C.B. 778.

In effect, if the proposed regulation were made final with the effective date provision unchanged, a foreign partnership with partners who are taxed under Subtitle A would have been retroactively relieved of their filing requirement.

The Taxpayer Relief Act of 1997 amended I.R.C. § 6031 by adding subsection (e), which provides that foreign partnerships are generally excluded from return filing requirements except as provided by regulations. On January 26, 1998, in response to the addition of I.R.C. § 6031(e), a withdrawal of notice of proposed rulemaking was published, withdrawing the 1986 proposed regulations and concurrently proposing new regulations under I.R.C. § 6031. 63 Fed. Reg. 3677 (1998). The new proposed regulations require a foreign partnership to file a return only in limited situations: if it has gross income derived from sources within the United States; if it has income that is effectively connected with a United States trade or business; or if it is making an election under I.R.C. § 703 that can only be made by the partnership.[5] Prop. Treas. Reg. § 1.6031(a)-1(b), 63 Fed. Reg. 3677 (1998).

The new proposed regulations, if finalized, would apply to partnership taxable years ending 90 days after the date published in the Federal Register; and would not apply to partnership taxable years beginning before January 1, 1999. 63 Fed. Reg. 3677 (1998). With regard to the impact of the new proposed regulations

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[5]The proposed regulations retain a rule from the current regulations which permits the service to require statements from a United States partner if the partner is reporting partnership items from a foreign partnership that is exempt from the I.R.C. § 6031 filing requirement.

on tax years subsequent to the enactment of TEFRA and prior to the making the regulations final, the preamble to the proposed regulations provides:

> A partnership that has followed the rules contained in section 1.6031-1 of the existing final regulations for all taxable years prior to the taxable year for which these new regulations will become effective will be treated as fully complying with the partnership filing requirements.

63 Fed. Reg. 3677 (1998).

Thus, it could be argued that the proposed regulations override the requirement by section 404 of TEFRA that a foreign partnership with U.S. partners file a return. Regardless, Temp. Treas. Reg. § 301.6233-1T(a) extends the TEFRA provisions to entities filing a partnership return. Thus, the TEFRA provisions are applicable by virtue of the filing of the partnership return, without regard to whether such a return was required by section 404 of TEFRA.

In sum, section 404 of TEFRA clearly requires a foreign partnership to file a return under I.R.C. § 6031 if the tax liability of a United States partner will be affected by items that flow from that partnership. Proposed regulations, however, have made it clear that the Service intends to waive the return filing requirement in certain situations. Nonetheless, the partnership filed a partnership return. The mere filing of the partnership return renders the examination and adjustment of the return as subject to the TEFRA procedures, without regard to whether the proposed regulation overrides section 404 of TEFRA. I.R.C. § 6233(a); Treas. Reg. § 301.6233(a)-1T(a).

Partnership Items

Having determined that the examination of the partnership return is subject to the TEFRA procedures, it must next be determined if the specific items at issue are partnership items. The tax treatment of partnership items is determined at the partnership level. I.R.C. § 6221. Thus, if the items at issue, interest income and interest expense, are partnership items, then the adjustment must be made through a TEFRA proceeding. I.R.C. § 6221.

A partnership item is any item required to be taken into account by Subtitle A for the partnership's taxable year to the extent it is determined by regulation that such item is more appropriately determined at the partnership level than at the partner level. I.R.C. § 6231(a)(3). The partnership aggregate and each partner's share of items of income, gain, loss, and deduction of the partnership are expressly defined by the regulations as partnership items. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i). Interest income is income of the partnership. I.R.C. § 61(a)(4). Interest expense is a deduction of the partnership. I.R.C. § 163(a). Thus, both the interest income and the interest expense are partnership items and are subject to the TEFRA unified audit and litigation procedures. I.R.C. § 6231(a)(3); I.R.C. § 6221.

Statute of Limitations

The general limitation on assessment of I.R.C. § 6501 controls the timing of when assessments of tax may be made against a taxpayer, even when that taxpayer is a partner of a partnership. Accordingly, a discussion of limitations on assessment must begin with an analysis of section 6501.

Section 6501 sets forth the general limitation on assessment and provides:

> (a) General Rule.--Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not the return was filed on or after the date prescribed) . . . For the purposes of this chapter, the term "return" means the return required to be filed by the taxpayer (and does not include a return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit).[6]

Under this provision, the time within which an assessment must be made is three years from the later of the due date for filing or the actual date of filing of the return. See I.R.C. § 6501(b)(1). For purposes of I.R.C. § 6501 (b)(1), the return at issue is the return of a partner or shareholder and not the return of the flow through entity. The Supreme Court in Bufferd v. Commissioner, 506 U.S. 523 (1993), held "that the limitations period within which the Internal Revenue Service must assess the income tax liability of an S corporation shareholder runs from the date on which the shareholder's return is filed." Id., 506 U.S. at 533. As the court noted, "tax returns that 'lack the data necessary for the computation and assessment of deficiencies' generally should not be regarded as triggering the period of assessment." Id., 506 U.S. at 528 quoting, Automobile Club of Mich. v. Commissioner, 353 U.S. 180, 188 (1957). Accordingly, the return of the flow-through entity does not trigger the running of the statute of limitations as to a member (i.e., partner/shareholder).

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[6]The last sentence of this provision was added by section 1284 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34 and "clarifies that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit." Conf. Rep. No. 105-220 at 702-703 (1997). Though the Act sets forth a prospective effective date, this provision does not substantively alter the law. See Bufferd v. Commissioner, 506 U.S. 523 (1993).

With the enactment of TEFRA, specific provisions affecting the limitation on assessment were enacted that are unique to TEFRA partnerships. First, the general limitation on assessment was amended by adding I.R.C. § 6501(n)(2),[7] which expressly provides: "For an extension of period in the case of partnership items (as defined in section 6231(a)(3)), see section 6229." Following this cross-reference leads to the minimum assessment period for adjustments attributable to partnership items.

Section 6229(a) sets forth a minimum period for assessing tax attributable to partnership items, and provides:

> (a) General Rule.--Except as otherwise provided in this section, the period for assessing any tax imposed by subtitle A with respect to any person which is attributable to any partnership item (or affected item) for a partnership taxable year shall not expire before the date which is 3 years after the later of--
>
> > (1) the date on which the partnership return for such taxable year was filed, or
> >
> > (2) the last day for filing such return for such year (determined without regard to extensions).

Simply stated, adjustments attributable to partnership items may be assessed within three years of the later of the date of filing or due date of the partnership return. In essence, I.R.C. § 6229 holds open the I.R.C. § 6501 limitation period as to all partners for a fixed period of time, thereby providing a minimum period within which to assess adjustments attributable to partnership items against all partners.

One exception to the controlling nature of I.R.C. § 6501 may be I.R.C. § 6229(b)(3), which states:

> Coordination with section 6501(c)(4).--Any agreement under section 6501(c)(4) shall apply with respect to the period described in subsection (a) only if the agreement expressly provides that such agreement applies to tax attributable to partnership items.

There are two possible interpretations of this provision. The better position is that this provision expressly authorizes a restricted consent, i.e., a consent to extend the period of limitations limited to specific issues. Pursuant to I.R.C. §

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[7]This provision has been renumbered numerous times since its enactment as part of Pub. L. No. 97-248; however, the language of the provision has remained unchanged.

6501(c)(4), the period for making an assessment may be extended by agreement. Similarly, pursuant to I.R.C. § 6229(b)(1), the minimum period for assessing partnership items may be extended by agreement. The impact of an extension agreement differs depending upon the nature of the extension agreement. An agreement to extend the I.R.C. § 6501 limitation period extends the period for assessing tax, without regard to the source of the adjustments. Conversely, an agreement to extend the I.R.C. § 6229 period extends the I.R.C. § 6501 assessment period only for partnership items. For an extension agreement to be limited to extending the I.R.C. § 6229 minimum assessment period for partnership items, the agreement must expressly state that it is limited to partnership items. I.R.C. § 6229(b)(3). The alternative view asserts that section 6229(b)(3) requires a statute extension to expressly refer to partnership items for that extension to apply to partnership items. The legislative history is consistent with this perspective. See Conf. Rep. No. 97-248 at 606 (1982).

Under the facts presented, the partnership returns were filed more than three years before assessment can be made. Furthermore, the partner's general period of limitations is held open only by virtue of a consent executed pursuant to I.R.C. § 6501(c)(4), and the consent fails to make to express reference to partnership items. Accordingly, we believe the period of limitation on assessment has expired.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Consents to Extend the Period of Limitations

[redacted]

Period of Limitations in the Event of Fraud

In certain situations, I.R.C. § 6229 provides for a longer period for assessment of tax attributable to partnership items. Those situations include when any partner has, with the intent to evade tax, signed or participated in the preparation of a return which includes a false or fraudulent item. Under section 6229(c)(1), a partner may be assessed at any time for any partnership or affected item, if the partner has, with the intent to evade tax, signed or participated directly or indirectly in the preparation of a partnership return which includes a false or fraudulent item. For all other partners, the minimum period for assessment under section 6229(a) is further extended to six years. For the tax years described in your incoming memorandum, the six year period would likewise be closed; however, the applicability of the unlimited assessment period of I.R.C. § 6229(c)(1)(A) should be considered. [redacted]

Please call if you have any further questions.

By: ______________________________
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