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
Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Proposed Closing Agreement Concerning a TEFRA Partnership and the Correlative Adjustments Following an I.R.C. § 482 Adjustment

This Field Service Advice responds to your memorandum dated September 8, 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

P1 =
P2 =
X =
Y =
Z =

R =
S =
T =

Year 1 =
Year 2 =
Year 3 =

$a =
$b =
$c =
$d =

$e =

ISSUES

Whether the proposed closing agreement correctly implements the proposed settlement offer of X, and does the proposed closing agreement adequately protect the Service's interests as to any other entity.

CONCLUSIONS

The proposed closing agreement does correctly calculate the amount of the correlative adjustments that follow from the application of I.R.C. § 482 and correctly implements the proposed settlement offer of X. However, the proposed closing agreement may not be able to adequately protect the Service's interest as to other entities because the Service cannot limit the § 482 adjustments to apply only to X.

FACTS

P1 is a TEFRA partnership with two equal corporate partners, X and Y. P1 owns all of the stock of R corporations (collectively called Z). Z are the partners of the P2 partnership.

The FPAA issued to P1 for Year 1 determined that P1 had earned $a in additional income, pursuant to an I.R.C. § 482 adjustment, as a result of a contract between P1 and P2.

X is not interested in establishing an account receivable under Rev. Rul. 65-17 as a way to conform P1's accounts because P1 would not be able to collect anything approaching $b from P2. Therefore, X has proposed to settle its case by deeming P1 to have recognized approximately $b of the proposed I.R.C. § 482 adjustment in Year 1. However, X also proposes that the Service agree to the correlative adjustments that follow from the application of I.R.C. § 482. The proposed correlative adjustments are as follows:

1) P1's income is increased by $b for Year 1, therefore, X's income, and its basis in its partnership interest in P1, is increased by $d for Year 1;

2) P1 is deemed to have contributed the $b collectively to the R corporations which collectively form Z (in proportion to each corporation's interest in P2), thereby increasing P1's aggregate basis in the stock of Z by $b;

3) Z are deemed to collectively contributed the $b to P2, thereby increasing Z's aggregate basis in P2 by $b;

4) In Year 2, P1 sells all of the stock of S of P1's corporations which collectively form Z to unrelated parties. P1's aggregate basis in the stock of these corporations had been increased (as a result of the I.R.C. § 482 adjustment) by $c. Therefore, P1 realizes a capital loss of $c, of which $e flowed through to X.

To protect the Government's interest as to other entities besides X, the proposed settlement agreement contains the following language:

> This agreement is between X and the Commissioner. P1 is not a party to this agreement. Any statement herein concerning P1 shall affect the federal income tax liability of X only, and shall not apply to Y, the other partner of P1. Furthermore, any statement herein concerning Z shall affect the federal income tax liability of X only, and shall not apply to Y, or to any other present or future shareholder of Z.

Y does not agree with X's settlement proposal. The reason the two partners of P1 disagree on the settlement proposal is because the two partners of P1 are in different tax situations. In Year 3, P1 sold all of the stock of several of the remaining corporations which collectively form Z. Under the proposed correlative adjustments, P1 would have a $b increased basis in Z. Therefore, P1 would have large capital losses in Year 3 on the sale of the stock instead of the small gains that were reported. X had large capital gains in a previous year which could be offset by carrying back theses large capital losses from the correlative adjustments, thus greatly diminishing the tax impact of X's share of P1's increase of income in the amount of $b for Year 1. Y, however, does not have any capital gains to be offset and does not receive any benefit from the settlement proposal.

LAW AND ANALYSIS

TEFRA

P1 is subject to the audit and litigation procedures of the Tax Equity & Fiscal Responsibility Act of 1982 (TEFRA), Pub.L. 97-248, 96 Stat. 324. Pursuant to I.R.C. § 6224(c)(1), a settlement agreement between the Secretary and one or more partners in a TEFRA partnership with respect to the determination of partnership items for any partnership taxable year shall be binding on all parties to such agreement with respect to the determination of partnership items for such partnership taxable year. I.R.C. § 6224(c)(2) further states that 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. Any settlement agreement that would otherwise qualify for consistent settlement that is entered into in a docketed case automatically gives all parties to the action the right to consistent treatment if they so request within 60 days of the date the agreement was entered into. Temp. Treas. Reg. § 301.6224(c)-3T(c)(3)(ii).

Section 6231(a)(2) defines "partner" as a partner in the partnership, and any other person whose income tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership. Section 6231(a)(3) defines a "partnership item" as any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

In the case at issue, X has proposed a settlement agreement with the Service in accordance with I.R.C. § 6224(c)(1). If the Service enters into the settlement agreement with X, the Service may be required, pursuant to I.R.C. § 6224(c)(2), to allow settlement terms to Y which are consistent with the settlement agreement entered into by X and the Service. As your request for Field Service Advice stated that your office is prepared to offer to Y the identical settlement terms as the terms in the proposed agreement at issue, this Field Service Advice will not go into further detail of the requirements of a consistent settlement.

Correlative Adjustments

Section 482 provides in part that:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Treas. Reg. § 1.482-1A(d)(2) provides in part that:

> Whenever the district director makes adjustments to the income of one member of a group of controlled taxpayers (such adjustments being referred to in this paragraph as "primary" adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. The correlative adjustment shall actually be made if the U.S. income tax liability of the other member would be affected for any pending taxable year. Thus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the U.S. income tax liability of the other member for any pending taxable year.

As noted above, the Service has alleged that P1 should have recognized an additional $a of income as a result of a transaction between P1 and P2. X has agreed to settle its portion of this adjustment by deeming P1 to have recognized an additional $b of income. In addition, the Service will apply the correlative adjustments that follow from the application of I.R.C. § 482.

In other words, P1 is deemed to have received additional income from P2. However, to explain the fact that P1 did not actually receive such additional income (and that it in fact never left P2), it is necessary to deem P1 to have re-transferred that amount back to P2. The simplest mechanism is to deem P1 to have contributed that amount collectively to the capital of Z (in proportion to each corporation’s interest in P2), and then to deem Z to have contributed that amount to P2. See e.g., Rev. Rul. 69-630, 1969-2 C.B. 112, and Rev. Rul. 78-83, 1978-1 C.B. 79. See also Treas. Reg. § 1.482-1A(d)(2). Therefore, the proposed settlement agreement does correctly calculate the amount of the correlative adjustments that follows from the application of I.R.C. § 482.

The proposed correlative adjustments increase X’s basis in its interest in P1, P1's basis in the stock of Z and the basis of the interest of Z in P2. See I.R.C. §§ 1016, 705(a)(1)(A), and 722. Because X included such amount in its income, you are willing to recognize these increases in basis as long as X owns (directly or indirectly) an interest in P1, Z, and P2.

However, you wish to prevent a party other than X from claiming the benefits of such increases in basis because you believe that otherwise the same loss would be claimed by multiple parties. Consequently, the proposed closing agreement would provide that the correlative adjustments would not apply in determining the Federal income tax liability of Y. Further, if X were to sell some or all of its interest in P1 or if P1 were to sell the stock of some or all of Z, the closing agreement would provide that any basis adjustment (as a result of the correlative adjustments) by P1 in the stock of Z or by Z in their partnership interest in P2 would not apply to any acquiring party. You have asked whether it is appropriate for the closing agreement so to provide.

With respect to Y, there is an argument that since Y did not include $d in income (as X did) following the I.R.C. § 482 adjustment, it would not be entitled to the benefits of the correlative adjustments if Y does not want to enter into a consistent settlement agreement with the Service.

However, we question whether there is any authority for not recognizing the correlative adjustments, i.e., the basis increases, that P1 would have in Z, and that Z would have in P2 if, for example, a third party were to acquire an interest in P1 or Z.

Generally, "the role of basis in the tax law is to identify the portion of a taxpayer's wealth that is exempt from future income taxation." Kohl, The Identification Theory of Basis, 40 Tax Law Review 623 (1985). In other words, if a taxpayer buys property (e.g., stock in a corporation or an interest in a partnership), its basis in that property is what it paid for such property. I.R.C. § 1012. Thus, when the taxpayer sells such property, it is only taxed on the difference between the value of the property it receives and its basis in such property. I.R.C. § 1001. See also Philadelphia Park Amusement Co. v. United States, 126 F.Supp. 184, 188-189 (Ct. Cl. 1954). In other words, it is not taxed on the entire amount of the proceeds since, to the extent of basis, such amount is presumed to have been previously taken into account.

In this case, X increased its basis in P1, P1 increased its basis in Z, and Z increased their basis in P2 by the amount of income recognized to X. In each case, the shareholder or partner is treated as having contributed such amount to the capital of its corporation or partnership. Such contribution results in an increase in the shareholder's or partner's basis in the corporation or partnership. See I.R.C. §§ 722 and 1016. Kasle v. United States, 75 F.Supp. 340 (N.D. Ohio 1947) . That is the case even though such amount is subsequently contributed down the chain. This is because P1 and Z continue to own indirectly such amount. Thus, once the amount is contributed to P1 (and to Z and to P2), the effect of the contribution cannot be taken away simply because someone else (X, P1 or Z) sold or transferred an interest in a corporation or partnership.

This point is also illustrated by the following hypothetical. X transfers its interest in P1 to a corporation ("Newco") in exchange for some of the stock of Newco. Simultaneously, other transferors transfer property to Newco in exchange for stock. Because the transferors (including X) collectively receive all of the stock of Newco, the exchanges qualify as tax-free under I.R.C. § 351. Consequently, Newco would take the same basis (including the correlative adjustments) in P1 as X had. I.R.C.

§ 362(a)(2). This result would apparently be allowed under the proposed closing agreement (since X would continue to indirectly own P1).

Subsequently, X sells its Newco stock. Under the proposed closing agreement, Newco's basis in P1 would be decreased by the amount of the correlative adjustment. Thus, if Newco later sells its interest in P1, Newco's gain or loss is higher or lower, respectively, than if the correlative adjustments were taken into account. However, Newco would argue that it was not a party to the closing agreement and is therefore not required to reduce its basis by the amount of the correlative adjustment. We are not aware of any authority that would require Newco to reduce its basis by the amount of the correlative adjustment.

Finally, if a shareholder sells its stock in a corporation, that sale has no effect on the basis of any asset (including stock in a corporation or an interest in a partnership) owned by that corporation. In other words, the sale only affects the basis of the stock in the corporation. The one exception is if the parties elect to apply I.R.C. § 338. In that case, the corporation being sold is treated as selling its assets to a new subsidiary of the acquiring corporation. The consequence is that the purchaser may allocate the purchase price for the stock among the assets (including stock in a corporation or an interest in a partnership) of the target corporation. I.R.C. § 338(b). Absent that provision, we are not aware of any authority for adjusting the basis of an asset in which the corporation holding such asset is sold. Thus, we do not recommend including in the closing agreement a provision which ignores the correlative adjustment upon a sale or transfer by X of its interest in P1 or by P1 of its interest in Z. We also do not believe that there are any revisions that could be made to the proposed closing agreement to prevent third parties from claiming the benefits of an increase in the basis if X were to sell some or all of its interest in P1 or if P1 were to sell the stock of some or all of Z.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Please call if you have any further questions.