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

SUBJECT: Status of Assessments of Tax on Agreed Increase in Partnership Discharge of Indebtedness Income Made as Computational Adjustments

This Field Service Advice responds to your memorandum dated March 12, 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 =
Date 1 =
Date 2 =
Date 3 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =

ISSUES

1. Whether the amount of discharge of indebtedness income of a partnership to be included in each partner's taxable income for the partner's taxable year is properly characterized as an affected partnership item which requires factual determinations at the partner level such that a notice of deficiency must be issued.

2. Whether assessments of tax on agreed increases in discharge of indebtedness partnership income made as computational adjustments as to the individual partners rather than pursuant to deficiency procedures are valid assessments.

3. Whether the Service may abate invalid assessments.

4. Whether the Service may refund payments of tax made in response to an invalid assessment.

5. Whether Counsel has an ethical obligation to advise the taxpayers of the invalid assessments and the possibility of filing a refund claim.

CONCLUSIONS

1. The amount of discharge of indebtedness income of a partnership to be included in each partner's taxable income for the partner's taxable year is properly characterized as an affected item which requires factual determinations at the partner level such that a notice of deficiency must be issued prior to assessment of the correlative tax.

2. Unpaid assessments of tax attributable to agreed discharge of indebtedness income made as computational adjustments as to the individual partners rather than pursuant to deficiency procedures are invalid assessments.

3. The Service may abate the amount of the invalid assessment that remains unpaid.

4. The Service may refund any amount paid within the applicable period of limitation on credit or refund. Such refund may be made with or without a claim having been filed by the taxpayer.

5. Counsel does not have an ethical obligation to advise taxpayers of an invalid assessment or a potential refund claim; and the act of advising the taxpayers could be a violation of the attorney's ethical obligations to the client (i.e., the Service.)

FACTS

A is a TEFRA partnership with one general partner and B limited partners. The Internal Revenue Service proposed an increase in partnership income of $ C as a result of discharge of indebtedness in that amount for the taxable year Year 1. The tax matters partner and notice partners agreed to the adjustment. The appropriate partners and the Internal Revenue Service executed Forms 870-P, binding all notice and non-notice partners to the agreements, on Date 1, Year 3.

Computational adjustments were made to increase the income of each partner by their allocable share of the agreed amount of increase in discharge of indebtedness income. The correlative tax due from each partner as a result of the increase in income was assessed. Notices of deficiency were not sent to the partners before making the correlative assessment.

A filed its Year 1 return on Date 2, Year 2. The returns of the partners have not been examined individually; it is likely that the returns of most partners for the Year 1 were filed timely on Date 3, Year 2. The relevant assessments were probably made before Date 1, Year 4, pursuant to section 6229(f)(1).

LAW AND ANALYSIS

Issue 1

A dichotomy exists "between, on the one hand, the procedures applicable to the determination and redetermination of deficiencies and, on the other hand, the procedures applicable to the administrative adjustment and judicial readjustment of partnership items." Maxwell v. Commissioner, 87 T.C. 779, 787 (1986) (emphasis in original). Items of partnership income, loss, deduction, or credit that affect each partner are to be determined at the partnership level. Id. ; I.R.C. § 6221. "Respondent has no authority to assess a deficiency attributable to a partnership item until after the close of a partnership proceeding." Id. at 788. Once the partnership proceeding has concluded, partnership items and computational affected items may be assessed by computational adjustment; whereas a statutory notice of deficiency must be issued for affected items that require factual determinations. N.C.F. Energy Partners v. Commissioner, 89 T.C. 741, 744 (1987). Thus, our threshold question is whether the assessment of tax attributable to discharge of indebtedness income is a partnership item or an affected item.

"[A] 'partnership item' means any item required to be taken into account for the partnership's taxable year to the extent prescribed by [the Commissioner's] regulations as an item that 'is more appropriately determined at the partnership level'." Maxwell v. Commissioner, 87 T.C. 783 (1986) (quoting I.R.C. § 6231(a)(3))

"An item whose existence or amount is dependent on any partnership item is an affected item." Id. At 791. Determination of the amount or the existence of discharge of indebtedness income of a partnership is more appropriately determined a the partnership level. Thus, it is a partnership item to which the TEFRA provisions rather than the deficiency provisions apply. I.R.C. § 6231(a)(3). Furthermore, each partner's distributive share of the discharge of indebtedness income is also a partnership item. Treas. Reg. 301.6231(a)(3)-1(a).

Generally, an item of partnership income is a partnership item, of which each partner's distributive share can be computed and the correlative increase in tax assessed through a computational adjustment. See Maxwell, 87 T.C. at 787; Crowell v. Commissioner, 102 T.C. 683, 689 (1994); I.R.C. § 6231(a)(3); Treas. Reg. § 301.6231(a)(3)-1(a)(1)(i). Income from discharge of indebtedness, however, is excluded from a partner's gross income if the partner is insolvent. I.R.C. § 108(a)(1)(B). A determination of insolvency is to be made at the partner level. I.R.C. § 108(d)(6). Because a partner level determination is required to determine whether the insolvency exception applies, the inclusion of the discharge of indebtedness income at the partner level is an affected item. See I.R.C. § 6231(a)(5).

Issue 2

To determine the validity of the assessments at issues, we must determine whether the inclusion into income of each partner's share of discharge of partnership discharge of indebtedness income is an affected item requiring only a computational adjustment from which the correlative increase in tax liability can be assessed or whether it is an affected item requiring factual determinations at the partner level which can be assessed only after issuing a notice of deficiency. No cases addressing the issue of the correct characterization of partnership discharge of indebtedness income with respect to a partner level adjustment have been identified; however, in a case in which the issue was whether a guaranteed payment from a partnership to a partner was to be excluded from the partner's income pursuant to Internal Revenue Code section 104(a) as compensation for injury or sickness, the Tax Court found that issuing a notice of deficiency was appropriate because the applicability of section 104(a) was "an item more appropriately determined at the individual level." Jenkins v. Commissioner, 102 T.C. 550, 555 (1994).

Whether an affected item may be assessed through a computational adjustment depends on whether the adjustment made to a partner's income "require[s] no additional factual determinations at the partner level other than a computation. " Bob Hamric Cheverolet, Inc. v. United States, 849 F.Supp. 500, 512 (W.D.Tex. 1994) (emphasis in original). Discharge of indebtedness income may be excluded if the partner is insolvent; the determination as to whether the partner is insolvent is

an additional factual determination other than a computation which must be made at the partner level. Therefore, an adjustment to the income of a partner who alleges that the partnership discharge of indebtedness income should be excluded due to his insolvency is an affected item which requires the Service to follow normal deficiency procedures including the issuance of a notice of deficiency. See Crowell v. Commissioner, 98 T.C. at 267; I.R.C. § 6230(a)(2)(A)(i). Thus, any assessment made without issuance of a statutory notice of deficiency is invalid. See I.R.C. § 6213(a) ("no assessment ... shall be made ... until such notice has been mailed to the taxpayer").

Issue 3

The Secretary is authorized to "abate the unpaid portion of the assessment of any tax . . . which -- . . . is erroneously or illegally assessed." I.R.C. § 6404(a)(3) (emphasis added). An assessment of a deficiency in income tax due to an affected item requiring a partner level determination made without issuing a notice of deficiency, securing a waiver of restrictions from the partner, or entering into an agreement with the partner which determines tax liability for a particular tax period is an erroneous or illegal assessment. Philadelphia & Reading Corp. v. United States, 944 F.2d 1063, 1072 (3d Cir. 1991); I.R.C. §§ 6213(a), 6230(a)(2)(A)(i), 7121. Therefore, the Secretary is authorized to abate the unpaid portion of the assessment of tax attributable to discharge of indebtedness income as to each partner.

Issue 4

With regard to refunding overpayments, section 6511(b) limits amount that may be refunded to amounts paid within two years of the filing of a claim for refund. Any refunds that are made are subject to this limitation. Note, however, that section 6402 does not require the taxpayer to file a claim for refund prior to the Service issuing a refund. Accordingly, the Service, of its own initiative, is legally permitted to credit or refund the illegally assessed amounts. The amount that may be refunded is limited to the amount paid within two years of the date the refund is allowed. I.R.C. § 6511(b)(2)(C). Any refund or credit made after the expiration of the period of limitation on credit or refund would be an erroneous refund. I.R.C. § 6514(a)(1). Lastly, it should be noted that the presence of an invalid assessment does not necessarily lead to the entitlement to a refund. To the extent there are offsets available, the Service would not be required to refund amounts collected in response to the invalid assessment. See Lewis v. Reynolds, 284 U.S. 281 (1932).

Issue 5

You have specifically inquired as to whether there is an ethical obligation to inform the taxpayers of the improper assessment. In ABA Formal Opinion 94-387

(September 26, 1994), the ABA concluded that the professional ethics rules do not require an attorney to inform an opposing party of an expired statute of limitations. The attorney is obligated, however, to inform the client of the defect. Also note, the ABA Formal Opinion concluded that the same rules apply to government attorneys, though the agency itself may have a duty to the public.

When applying this opinion to the Office of Chief Counsel, our client is, and hence we owe a duty to, the Internal Revenue Service. Nonetheless, CCDM 30.4.8.7 (April 15, 1999) states that "our legal practice and conduct should always be characterized by adherence to the highest standards of professionalism, honesty, and fair play." The Internal Revenue Service, in conjunction with its own policy statements must determine whether it will contact the taxpayers and advise them that improper assessment procedures were utilized; however, as counsel to the Internal Revenue Service, we should recommend that the agency notify the taxpayers of the technical defect in the assessments.

Please call if you have any further questions.