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

MEMORANDUM FOR JUNE Y. BASS
ASSOCIATE AREA COUNSEL (LMSB)

FROM: David R. Haglund
Senior Technician Reviewer CC:PSI:B01

SUBJECT:

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LEGEND

A =

B =

C =

D =

E =

F =

G =

H =

I =

J =

K =

L =

M =

N =

O =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

n =

o =

p =

q =

d1 =

d2 =

d3 =

d4 =

d5 =

d6 =

d7 =

d8 =

d9 =

d10 =

ISSUES

(1) Whether the sale of a f percent interest in B, a TEFRA partnership, by K, an LLC owned by F and L, to H, an S corporation wholly owned by F, on d1, terminated the partnership.

(2) If a partnership return on Form 1065 erroneously covers a full year in spite of the partnership's constructive termination, is that filing a "return" for statute of limitations purposes?

CONCLUSIONS

(1) Yes, pursuant to I.R.C. section 708(b)(1)(B), the partnership was terminated on d1 when K sold its f percent interest in the partnership to H.

(2) Yes, under a case-by-case test used by the courts to evaluate flawed returns, the filing would start the running of the statute of limitations on assessment. Although two short-year returns should have been filed in light of the partnership termination, the full-year filing will start the running of the statute for both short years.

FACTS

A hosts a (Show). A has hosted Show for approximately twenty years.

B is one of four entities that held an ownership interest in certain assets germane to A and Show. The other entities owning interests are C, D, and E (collectively referred to herein as "Taxpayer Entities"). The Taxpayer Entities sold most of the assets underlying the Show.

F is the sole shareholder of C. F also owns all of the shares of E and G. F directly or indirectly owns all of D (E a%, F b%, and G c%). F is the sole shareholder of H, a non-TEFRA S corporation. B is owned d percent by I, e percent by J, and f percent by K. K is a non-TEFRA partnership owned g percent by F and h percent by F's wife, L.

On d1, K sold its f percent interest in B to H for a promissory note in the amount of $i. It appears that the promissory note payable to K was paid when the related entities sold the Show assets in d2. The price of the f percent interest in B was determined by the appraised value of the Show related assets that B owned in d3. From the sale of its interest in B, K reported $i as the amount realized, less cost or other basis for a total gain of $j. B continued its business activities and filed a Form 1065, partnership return, purporting to cover the entire year (d4). The return was filed under B's employer identification number and was signed by a partner authorized to sign on behalf of both the terminated and continuing partnerships. Short year returns covering the periods d5 and d6 were not filed.

The filed partnership return for B shows the ownership of the following partners on the Forms K-1:

1. I, an individual, owned d percent before the termination on d1 and d percent at the end of the partnership's taxable year, d7, of the partnership profits and capital;

2. J an individual, owned e percent before the termination on d1 and e percent at the end of the partnership's taxable year, d7, of the partnership profits and capital;

3. K, a partnership, owned f percent before the termination on d1 and k percent at the end of the year of the partnership's taxable year, 12/28/97, of the partnership profits and capital; and

4. H, an S corporation, owned k percent before the termination on d1 and f percent at the end of the partnership's taxable year, d7, of the partnership profits and capital.

On d8, the Taxpayer entities entered into a contract to sell most of the Show related assets to unrelated third parties, M and its parent corporation, N (the Buyers). To determine the value of the assets of the Show, the Buyers hired an independent appraiser in the industry, O, to appraise the assets as of d9 (the Appraisal). According to the Appraisal, the total value of the Show was $l. However, the sales contract shows a purchase price of $m. Of the sales price, B received approximately $n for selling the following Show assets during d3:

1. on the tax return: sold for $o;

2. B on the tax return: sold for $p; and

3. Other fixed assets: sold for $q.

LAW AND ANALYSIS

Issue #1 Partnership Termination

Under section 708(a) of the Internal Revenue Code a partnership shall be considered as continuing if it is not terminated. A termination occurs only where no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or where there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits within a 12-month period. Section 708(b).

For purposes of the 50 percent sale or exchange of the partnership interest, a sale or exchange to another member of the partnership and the exchange of one partnership interest for another interest in another partnership are included. Treas. Reg. section 1.708-1(b)(2). The partnership taxable year closes with respect to the partners if there has been a termination of the partnership. Section 1.708-1(b)(3). The date of the termination is the date of the sale or exchange of the 50 percent partnership interest. Id. Under Treas. Reg. section 1.708-1(b)(4), upon termination

of a partnership by a sale or exchange of an interest, the following is deemed to occur:

> The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up.

While the attribution rule of section 707(b) applies to whether or not a partner may recognize a loss on the sale of a partnership interest, these rules have no application to terminations under section 708(b). The court in *Evans v. Commissioner*, held that a termination of a partnership occurred under section 708 where a 50 percent partner assigned his entire partnership interest to his wholly owned corporation. 54 T.C. 40 at 50-51 (1970).

Here, K sold its f percent interest in B to H on d1. Consequently, there was a termination of the B partnership, on d1 under section 708(b)(1)(B). A new partnership was deemed formed with the remaining partners and H on d10.

Issue #2 Return for Statute of Limitations Purposes

Section 443(a)(2) of the Internal Revenue Code requires a short-year return to be filed if the taxpayer exists for only part of what otherwise would be its taxable year.

Section 706 provides rules for determining the taxable year of a partnership. The accompanying regulations provide that upon a partnership termination, the partnership taxable year closes for all partners as of the date of the termination. Treas. Reg. section 1.706-1(c)(1).

Section 708(b)(1)(B) provides that a partnership terminates for tax purposes upon the sale or exchange of at least 50% of the total interest in partnership capital and profits within a 12-month period.

Section 6031(a) provides that every partnership must make a return for each taxable year, stating specifically its gross income, allowable deductions and other required items.

Section 6063 provides that a partnership tax return must be signed by one of the partners. Section 6063 further states that a partner's signature on the return is prima facie evidence that he or she is authorized to sign the return on behalf of the partnership.

Section 6109 requires identifying numbers to be included on tax returns and other documents. The accompanying regulations state that when a partnership constructively terminates under section 708(b)(1)(B), the new partnership created by the termination retains the employer identification number of the terminated partnership. Treas. Reg. section 301.6109-1(d)(2)(iii); *see also* I.R.S. Notice 2001-5, I.R.B. 2001-3, 327.

Section 6229(a) states that tax attributable to partnership items arising in a given year may be assessed until three years after the later of:

i) the filing of the partnership return for that year; or
ii) the due date of the return for the year (determined without regard to extensions).

Section 6229(c)(3) states that tax attributable to partnership items arising in a given year may be assessed at any time where the partnership fails to file a return for that year.

Section 6501(a) provides generally that any tax imposed under the Code shall be assessed within three years after the return is filed. Section 6501(c)(3) provides that tax for a given year may be assessed at any time if no return is filed for the year.

In the present case, a partner in B sold its f% interest on d1, thereby triggering a termination of the partnership under section 708(b)(1)(B). B should have filed a short-year return for the period ending d1, because the termination caused its taxable year to close on that date. *See* Code section 443(a)(2); Treas. Reg. section 1.706-1(c)(1). Similarly, the new partnership generated by the termination should have filed a return for its taxable year beginning d10. *See* Code section 443(a)(2); I.R.S. Notice 2001-5, 2001-3 I.R.B. 327.

As noted above, B did not comply with this requirement to file short-year returns. Instead, one return was filed purporting to cover the period d4. Area Counsel has asked whether this single filing constitutes a “return” for B’s short taxable year d5 or for the newly formed partnership’s short taxable year d6. For the reasons stated below, the return would start the running of the statute of limitations for assessment with respect to both of these short periods.

The Tax Court has stated (in the context of section 6501) that a document must satisfy four elements to be considered a “return” for statute of limitations purposes. *Beard v. Commissioner*, 82 T.C. 766,777 (1984), *aff’d per curiam*, 793 F.2d 139 (6th Cir. 1986). First, the document must contain sufficient data to calculate tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury. *Id.* at 777.

In the present case, Area Counsel indicates that the full-year return provides the Service with enough information to calculate tax liability for the two short years. The return therefore satisfies the first element of *Beard*.

With respect to the second element, the full-year return was filed on the proper form for a partnership return, included the required Form K-1s and bore no alterations to the form's official text. Accordingly, there seems to be no basis for denying that the document purports to be a return.

With regard to the third element, Area Counsel believes the partners in A & B apparently made an honest and reasonable attempt to comply with applicable law. Area Counsel believes the partners may simply have been unaware that the sale of a f% interest terminated B. The taxpayers, therefore, could seemingly make a strong case that they have complied with the third *Beard* factor.

Finally, with regard to the fourth element, an individual who was a partner in both B and the newly formed partnership signed the full-year return under penalties of perjury. In other words, an individual who could have properly signed each of the short-year returns under section 6063 signed the full-year return. For purposes of the fourth *Beard* element, therefore, it seems clear that an appropriate taxpayer signed the full-year return.

The decision in *Beard* does not specifically address section 6229, which, as noted above, sets forth the statute of limitations rules applicable to partnership returns. Section 6229(c)(3) provides that failure to file a partnership return leaves the statute of limitations for assessment open indefinitely. Thus, if a return is so flawed that the partnership is treated as filing no return, the Service may assess at any time.

Research indicates only one case under section 6229(c)(3) addressing the question of whether a flawed partnership return starts the running of the statute of limitations. In a recent Tax Court case, the Service argued that a partnership failed to file a return for purposes of section 6229(c)(3) because no partner signed the return. *Agri-Cal Venture Associates v. Commissioner*, 80 T.C.M. (CCH) 295 (2000). In light of this failure, the Service argued, the statute of limitations on assessment must be held open indefinitely. The Tax Court agreed, stating that "… only a return as required by the Internal Revenue Code (a valid return) will fix the time for the running of the period to assess tax (i.e., the statute of limitations)". *Id*. at 301.

The *Agri-Cal* decision could be read broadly to mean that any partnership return not filed in accordance with the Code will leave the statute of limitations open under section 6229(c)(3). Under this reading, the statute would remain open in the present case, since filing a full-year return instead of two short-year returns was clearly erroneous under the Code provisions cited above. In effect, this reading would supercede the *Beard* test in the context of partnership returns, since that test holds that even a significantly flawed return can begin the running of the statute.

The Tax Court did not state in *Agri-Cal*, however, that it is departing from the general test set forth in *Beard*. Moreover, the result in *Agri-Cal* (no valid return filed) is consistent with *Beard*, since the return in *Agri-Cal* would have failed to satisfy the fourth element of the *Beard* test (signature by the taxpayer under penalty of perjury). Accordingly, *Agri-Cal* should not be read as superceding the *Beard* test, and that test should apply here to weigh the strength of the Service's case on the statute of limitations issue.

You should note, moreover, that the facts of the present case are distinguishable from those in *Agri-Cal*. The partnership in *Agri-Cal* failed to obtain a partner's signature on the return. In the present case, the return was signed by an individual who was a partner in both B and the newly formed partnership, thus reflecting compliance with the rule of section 6063 that partnership returns must be signed by a partner.

A Supreme Court decision addressing use of an incorrect tax form also supports the conclusion that the full-year return filed in the present case started the running of the statute. *See Germantown Trust Co. v. Commissioner*, 309 U.S. 304 (1940). In *Germantown Trust*, a taxpayer taxable as a corporation incorrectly viewed itself as a trust, and thus filed its return on Form 1041. The Court held that despite this error, the Form 1041 should be considered a "return" for statute of limitations purposes. *Id*. at 309. The Court noted that the return contained "all of the data from which a tax could be computed and assessed although it did not purport to state any amount due as tax". *Id*. at 308. The return, therefore, was held sufficient to start the period of limitations. *Id*. The return in the present case was also presented on the "wrong form" in a sense, since two separate short-year returns should have been used instead of a full-year return. As in *Germantown Trust*, however, the return contained adequate data from which the Service could calculate the tax liability.

The Supreme Court has further held as follows with regard to whether a return starts the running of the statute of limitations on assessment:

> [p]erfect accuracy or completeness is not necessary to rescue a return from nullity, if it purports to be a return, is sworn to as such… and evinces an honest and genuine endeavor to satisfy the law. This is so though at the time of filing the omissions or inaccuracies are such as to make amendment necessary.

Zellerbach Paper Co. v. Helvering, 293 U.S. 172, 180 (1934)(citation omitted). Although the return in the present case was flawed, taxpayer could strongly argue that the return satisfied the standards of *Zellerbach*. As noted above, the full-year filing purported to be a return, was sworn under penalties of perjury and seemingly reflected a good faith effort to satisfy the law.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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