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 ALICE M. HARBUTTE
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FROM: Barbara A. Felker
Chief, CC:INTL:Br3

SUBJECT:

Tax Matters Partner)

This Chief Counsel Advice responds to your memorandum dated March 26, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

HybridJV =

date a =
USPartner1 =

USPartner2 =
UKSub1 =
UKHolding =
UKSub2 =
date b =
date c =
date d =
date e =
date f =
date g =
amount a =
amount b =
amount c =
amount d =
amount e =
amount f =

amount g =
amount h =

ISSUES

1. Whether, with regard to the foreign tax credit, the amount of foreign income taxes deemed paid under sections 902(a) and 960 of the Internal Revenue Code, the amount of the corresponding section 78 “gross up”, the classification of income and foreign taxes under section 904 to separate categories of income, and the creditability of the U.K. windfall tax paid by UKSub1, are partnership items of HybridJV under section 6231(a)(3).

2. Whether a TEFRA proceeding must be commenced with respect to the Notice of Inconsistent Treatment filed by USPartner2 relating to the creditability of the U.K. windfall tax.

CONCLUSIONS

1. Since the taxes for which a foreign tax credit is being claimed by the partners in HybridJV are claimed as deemed paid credits under section 902 or 960 and not as direct credits under section 901 the credits are not partnership items. However, classification under section 904 to separate categories of income of the dividends received by HybridJV from UKHolding is a partnership item.

2. TEFRA proceedings need not be commenced in response to the Notice of Inconsistent Treatment filed by USPartner2 relating to the U.K. windfall tax since creditability of that tax is not a partnership item.

FACTS

HybridJV is a joint venture (50/50) formed in date a by two unrelated U.S. corporations, USPartner1 and USPartner2. HybridJV was formed as a United Kingdom private company for the purpose of acquiring UKSub1. On date b, HybridJV acquired 100% of UKHolding. UKHolding has numerous wholly owned subsidiaries, including UKSub1. UKSub1 wholly owned UKSub2.

Although a U.K. private company, HybridJV elected to be treated as a partnership for U.S. tax purposes by checking box 2(e) on Form 8832, effective date c. HybridJV indicated on its U.S. Return of Partnership Income, Form 1065, filed for its year ending date d (the "1997 Form 1065") that it was a foreign partnership and designated USPartner1 as tax matters partner ("TMP"). Both USPartner1 and USPartner2 signed an election for HybridJV to be treated as a TEFRA partnership for U.S. tax purposes for the 1997 tax year.

The USPartner1 consolidated group claimed foreign tax credits on its U.S. Corporation Income Tax Return, Form 1120, for its 1997 taxable year. Of those

claimed credits, amount a related to foreign taxes shown as accrued on the 1997 Form 1065. HybridJV identified those foreign taxes as associated with "Dividends" that accrued on date e. The 1997 Form 1065 reported total dividend income in the amount of amount b, classified as amount c of UK/Northern Ireland general limitation income, amount d of UK/Northern Ireland passive income, and amount e as UK/Northern Ireland dividends from section 902 Corp #1. The reported dividend income included the "gross-up" amounts under section 78 of the Code.

On date f, USPartner1, as TMP of HybridJV, filed a Form 8082, "Notice of Inconsistent Treatment or Administrative Adjustment Request", with respect to the 1997 Form 1065. The Form 8082 requested that it be treated as an Administrative Adjustment Request ("AAR"), and requested substitute return treatment for the entire partnership.

The AAR substitute return reported several changes to the amounts reported on the 1997 Form 1065. The AAR substitute return reported a revised amount of foreign taxes accrued of amount f reduced from amount a as originally reported. The AAR states that the amount was adjusted "to reflect the actual tax liability of the foreign corporations". The amount f is described as the total foreign taxes deemed paid under section 902 of the Code with regard to the dividends paid in 1997 by UKHolding to HybridJV.

The AAR substitute return also reduced the amount of reported dividend income from amount b to amount g because of changes made to UKHolding's earnings and profits and a correction to the amount of cash distributed and section 78 gross-up amounts with respect to the dividends from UKHolding. The revised dividend income was classified as amount g of UK/Northern Ireland general limitation income. Also, the Schedule M-1 amounts were adjusted to report that HybridJV received a distribution of previously taxed income from UKSub1 through UKHolding that should have been reported as book income on line 1 of that schedule and also reported as book income not included as taxable income on line 6 of that schedule. The revised dividend income amount of amount g does not include the previously taxed income.

UKSub1 paid U.K. windfall tax in the amount of amount h, one-half paid on date d, and one-half paid on date g. HybridJV did not include this amount as a foreign tax paid or accrued on either the 1997 Form 1065 or on the AAR substitute return. However, USPartner2 has filed a Notice of Inconsistent Treatment, Form 8082, claiming additional foreign tax credit for its share of that amount since it asserts that the U.K. windfall tax is, contrary to the position taken by HybridJV, a creditable foreign income tax.

LAW AND ANALYSIS

The partnership provisions in Title IV of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, sec. 401-407, 96 Stat. 324, 648-71, established

a unified audit and litigation process under sections 6221 through 6233 of the Code for determining the tax treatment of partnership items at the partnership level. For partnership tax years beginning after September 3, 1982, these TEFRA provisions effectively replace the procedures generally applicable to the determination of tax deficiencies and overpayments under sections 6211 through 6215 with special procedures applicable to the administrative adjustment and judicial readjustment of partnership items under sections 6221 through 6233. *See Addington v. Commissioner*, 205 F.3d 54 (2d Cir. 2000), *aff'g Sann v. Commissioner*, T.C. Memo. 1997-259; *Randell v. United States*, 64 F.3d 101, 103 (2d Cir. 1995), *cert. denied*, 519 U.S. 815 (1996); and *Maxwell v. Commissioner*, 87 T.C. 783 (1986).

In the interest of providing consistent treatment for all partners in a partnership, the TEFRA partnership provisions require adjustments to "partnership items" to be made at the partnership level in a separate TEFRA partnership proceeding. Section 6221 of the Code. Under those provisions, the Service is generally prohibited from assessing a deficiency regarding a partnership item without first making the appropriate adjustments to the partnership items in a partnership proceeding. Section 6225(a). Because section 6226 makes the issuance of a Notice of Final Partnership Administrative Adjustment (" FPAA") a condition precedent to the exercise of its jurisdiction over a partnership action, the Tax Court has no jurisdiction over partnership items until an FPAA is issued for the partnership. *Maxwell v. Commissioner*, 87 T.C. at 789. Neither the Service nor the taxpayer is permitted to raise non-partnership items in the course of a partnership proceeding, nor may partnership items be raised in proceedings relating to non-partnership items of a partner unless the partnership items are converted to non-partnership items. H. Rep. 97-760, 97th Cong., 2d Sess. at 611 (1982), 1982-2 C.B. 600 at 668; *Maxwell v. Commissioner*, 87 T.C. at 788. Failure to conduct a partnership level TEFRA proceeding would bind the Service on any item or items on the partnership Form 1065 and books and records of the partnership that were required to be taken into account by the partnership under subtitle A of the Code, and which are also partnership items as defined under the regulations. *Doe v. Commissioner*, 97-1 U.S.T.C. ¶50,460 (10th Cir. 1997); *Roberts v. Commissioner*, 94 T.C. 853 (1990); *Estate of Quick v. Commissioner*, 110 T.C. 172 (1998). The Service, however, may adjust non-partnership items, including affected items, under the deficiency procedures of sections 6211 through 6215. See *Jenkins v. Commissioner*, 102 T.C. 550 (1994); *Maxwell v. Commissioner*, 87 T.C. at 787. Therefore, the determination of whether an item is a partnership item is the threshold question in determining the applicable deficiency procedures.

Section 6231(a)(3) of the Code defines a "partnership item" as any item that is required to be taken into account for the partnership's taxable year under any provision of subtitle A of the Code to the extent that the Treasury regulations provide that the item is more appropriately determined at the partnership level than at the partner level. *N.C.F. Energy Partners v. Commissioner*, 89 T.C. 741 (1987). The Treasury regulations define partnership items to include "the partnership's

aggregate and each partner's share of ... items of income, gain, loss, deduction, or credit of the partnership ... [and] expenditures by the partnership not deductible in computing its taxable income." Treas. Reg. §301.6231(a)(3)-l(a)(1)(i) and (ii). Partnership items also include the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, and deduction. Treas. Reg. §301.6231(a)(3)-l(b). Thus, the determination of "each partner's share" of a partnership's income, gain, loss, deductions, or credits is a partnership item that can only be adjusted in a partnership proceeding. *See Hambrose Leasing 1984-5 Limited Partnership v. Commissioner*, 99 T.C. 298 (1992) (allocating partners' share of losses); *Woody v. Commissioner*, 95 T.C. 132 (1990) (allocating guaranteed payments among partners).

An "affected item" is any item on a partner's return to the extent that it is affected by a partnership item. Section 6231 (a)(5) of the Code; *Jenkins v. Commissioner*, 102 T.C. at 554. Affected items can be the subject of computational adjustments (which the Service can make to reflect the adjustment of partnership items without issuing a notice of deficiency), see section 6231(a)(6), or adjustments that require a factual determination at the individual partner level (using the deficiency procedures). See *N.C.F. Energy Partners v. Commissioner*. Adjustments to either type of affected item may be determined only after the partnership item or items upon which it is based are established. Accordingly, a notice of deficiency issued to a partner before the final resolution of the partnership item to which the affected item relates would be invalid. *See GAF Corp. v. Commissioner*, 114 T.C. 519, 524-526 (2000). Partnership items determined in the TEFRA partnership proceeding will be res judicata in the affected item notice of deficiency proceeding. *Dial USA v. Commissioner*, 95 T.C. 1 (1990). By definition, affected items are not partnership items; thus, they are not subject to determination at the partnership level. Section 6230(a)(2)(a)(i) authorizes the Service to issue a notice of deficiency for affected items that require partner level determinations. Further, if the Service is not contesting the partnership items as reported by the partnership, the Service is not required to conduct an examination of the partnership returns before issuing a notice of deficiency to contest an affected item. *See Jenkins v. Commissioner*, 102 T.C. at 566; *Roberts v. Commissioner*.

All non-partnership items on a partner's income tax return continue to be subject to the generally applicable rules for administrative and judicial resolution of the partner's tax liability.

1. Foreign tax credit

Section 702(a)(6) of the Code provides that each partner shall take into account separately his distributive share of the taxes described in section 901 paid or accrued by the partnership to foreign countries and to possessions of the United States. *See also* Treas. Reg. §1.702-1(a)(6). Section 703(a)(1) requires the

partnership to separately state these amounts on the partnership return. Thus, the amount and eligibility for credit under section 901 and the separate limitation classification under section 904 of taxes paid or accrued by a partnership are items the partnership is required to take into account under subtitle A of the Code. Accordingly, they are properly characterized as partnership items pursuant to Treas. Reg. §301.6231(a)(3)-1(a) (1)(i), (ii) and (b), as credits of the partnership, nondeductible expenditures, and underlying legal and factual determinations affecting credits, respectively. Here, however, HybridJV did not pay or accrue any foreign income taxes. Partnerships are not eligible to claim deemed paid credits under sections 902 and 960, which apply only to domestic corporations owning stock in foreign corporations.

Taxes deemed paid by HybridJV's domestic corporate partners USPartner 1 and USPartner 2 under section 902 or 960 of the Code attributable to taxes paid or accrued by U.K. corporations UKHolding, UKSub1, and UKSub2 in which the partners owned the required amount of voting stock under section 902(a) or 960(a)(1) are not credits "of the partnership" and need not be separately stated on HybridJV's return. Therefore, they are not partnership items. However, USPartner 1's and USPartner 2's entitlement to the deemed paid foreign tax credit in the amount f is dependent, in part, upon establishing ownership of the requisite amount of voting stock in UKHolding, UKSub1, and UKSub2. To the extent the amount of HybridJV's stock ownership in UKHolding is relevant to this determination, the amount of the deemed paid credit under section 902 or 960 and corresponding section 78 "gross-up" are affected items. In contrast, other items relevant to the determination of the proper amount of deemed paid credit and section 78 "gross-up," such as the computation of the U.K. corporations' post-1986 undistributed earnings and post-1986 foreign income taxes pools, are not determined at the partnership level and so are neither partnership items nor affected items. Accordingly, whether the U.K. windfall tax paid by UKSub1 on dates d and g is a creditable income tax under section 901 is neither a partnership item nor an affected item. However, classification under section 904 to separate categories of income of the dividends in the amount g received by HybridJV from UKHolding is a partnership item since that determination is made at the partnership level.

2. TEFRA proceeding with respect to the Notice of Inconsistent Treatment

UKSub1 paid U.K. windfall tax in the amount of amount h, one-half paid on date d, and one-half paid on date g. HybridJV did not include this amount as a foreign tax paid or accrued on either the 1997 Form 1065 or on the AAR substitute return. However, USPartner2 has filed a Notice of Inconsistent Treatment, Form 8082, claiming additional foreign tax credit for its share of that amount since it asserts that the U.K. windfall tax is, contrary to the position taken by HybridJV, a creditable foreign income tax. Since, as discussed above, the item for which USPartner2 has filed the Form 8082 is not a partnership item, TEFRA proceedings are inapplicable.

Although not raised in your March 26, 2001, memorandum, we note that this case may present section 1503(d) of the Code issues. As stated above, HybridJV is a U.K. private company owned by two unrelated U.S. corporations, USPartner1 and USPartner2, and classified as a foreign partnership for U.S. tax purposes. Also as stated above, during its 1997 tax year, HybridJV incurred interest expense. The HybridJV partnership interests of USPartner1 and USPartner2 each constitute a separate unit under Treas. Reg. §1.1503-2(c)(3)(i)(B) and a dual resident corporation (DRC) under Treas. Reg. §1.1503-2(c)(2). The partnership interests may also constitute hybrid entity separate units under Treas. Reg. §1.1503-2(c)(4). Whether each DRC incurred a dual consolidated loss for the year at issue may depend on the effect, if any, on that determination of deemed dividends pursuant to subpart F and distributions of previously taxed income. Additionally, the mirror provision in Treas. Reg. §1.1503-2(c)(15)(iv) may apply to any dual consolidated losses of the DRCs. If the mirror provision applies, the losses may not be used in the United States.

Please call if you have any further questions.

BARBARA A. FELKER
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