OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
March 17, 2000

Number: **200025017** TL-N-6066-99
Release Date: 6/23/2000 CC:DOM:FS:P&SI

UILC: 754.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR NORTHERN CALIFORNIA DISTRICT COUNSEL

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

SUBJECT: Section 754 Election

This Field Service Advice responds to your memorandum dated November 19, 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:

T =
S =
C =
P =
A =
Year 1 =
Year 2 =

ISSUE:

Whether a partnership has made a valid election under section 754 in Year 1.

CONCLUSION:

Additional facts are needed to determine whether the partnership has made a valid election under section 754.

FACTS:

S is a wholly-owned subsidiary of T. C is a wholly-owned controlled foreign corporation of S. C is a general partner in P, a German joint venture. In Year 1, C purchased an additional interest in P.

In Year 1, T filed a consolidated Form 1120, U.S. Corporation Income Tax Return, including S. Attached to the Form 1120 were numerous Forms 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations. During the examination of the Form 1120, T filed an amended Form 5471.

P was not required to file a tax return in Year 1. As part of T's consolidated return, T included a Form 1065, U.S. Partnership Return of Income, for P for Year 1. Included in the Form 1065 is the following statement:

> [C], a foreign corporation, ("[C]") attaches this statement to [T]'s ("[T]") consolidated tax return for the [Year 1] taxable year, as required by Income Tax Regulations § 1.743-1(b)(3), for the purchase of addition partnership interests in [P], a German entity ("[P]"). The consequential increase in basis in [P] assets does not impact [T]'s federal income tax calculation but does affect [T]'s California unitary tax liability and thus this notice is included in order to perfect the § 754 election in order to satisfy California Revenue & Tax Code § 23051.5. In reliance on the holding in Atlantic Veneer Corporation v. C.I.R., 812 F.2d 158 (1987), [T] is attaching herewith a pro forma partnership income tax return (Form 1065) for [P] and the Election to adjust the basis in [P] assets pursuant to § 754 of the I.R.C. of 1986.

The Form 1065 also included the following statement entitled "Election to Adjust Basis of Partnership Property under § 754 (Reg. § 1.754-1(b)" which provided:

> [P], a partnership for U.S. federal income tax purposes (but not a U.S. taxpayer or filer), hereby elects under IRC § 754 to apply the provisions of §§ 734(b) and 743(b) beginning with calendar [year 1].

The Form 1065 and election were signed by A, the President and Chief Executive officer of P. T claims it also filed the Form 1065 with the Philadelphia Service Center.

In Year 2, C purchased an additional interest in P. In addition, four of T's subsidiaries, including S, purchased an interest in P. P was not required to file a tax return in Year 2. As part of T's consolidated return, T included a Form 1065 for P for Year 2. Included in the Form 1065 is the following statement entitled "Election to Adjust Basis of Partnership Property under § 754 (Regulation § 1.754-1(b)" which provided:

> [P], a partnership for U.S. federal income tax purposes (but not a U.S. taxpayer or filer), hereby elects under IRC § 754 to apply the provisions of §§ 734(b) and 743(b).
>
> [P] is making this election in order to perfect the IRC § 754 election for Federal income tax law purposes.

The Form 1065 and election were signed by A, the President and Chief Executive Officer of S.

LAW AND ANALYSIS

Section 754 Election

If a partnership files an election, in accordance with the treasury regulations, the basis of partnership property is adjusted in the case of a transfer of partnership interest in the manner provided in section 743. I.R.C. § 754. Such an election applies with respect to transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent years. I.R.C. § 754; Treas. Reg. § 1.754-1(a). An election under section 754 must be made in a written statement filed with the partnership return for the taxable year during which the transfer occurs. Treas. Reg. § 1.754-1(b)(1). The statement must set forth the name and address of the partnership making the election, be signed by any one of the partners, and contain a declaration that the partnership elects under section 754 to apply the provisions of section 734(b) and 743(b). Treas. Reg. § 1.754-1(b)(1). If a valid election has been made under section 754 for a preceding taxable year and not revoked, a new election is not required to be made. Treas. Reg. § 1.754-1(b)(1).

Any election affecting the taxable income derived from a partnership must be made by the partnership. I.R.C. § 703(b). An election as to the method of computing depreciation must be made by the partnership and not by the partners separately. Treas. Reg. § 1.703-1(b)(1).

Every partnership is required to file a return for each taxable year. I.R.C. § 6031(a). The return must be signed by a partner. I.R.C. § 6063. No return is required, however, for a foreign partnership carrying on no business in the United States and deriving no income from sources within the United States. Treas. Reg. § 1.6031-1(d)(1).

Where a United States citizen is a partner in a partnership which is not required to file a United States return because it does no business in the United States, and the citizen desires an election in accordance with the provisions of section 703 to

be made by or for the partnership, a return must be filed by the partnership. Treas. Reg. § 1.6031-1(d)(2). The filing of a return for a taxable year of the partnership by a citizen or resident partner constitutes a filing for the partnership of such partnership return. Treas. Reg. § 1.6031-1(d)(2).

Whether the Form 1065 on which P made the election under section 754 was filed with the Philadelphia Service Center should be verified. It is unclear if A had the authority to sign the Form 1065 on behalf of a partner. If the facts establish that the return was so filed, and A did have the necessary authority, P made a valid section 754 election. If valid, such an election applies with respect to transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent years. I.R.C. § 754; Treas. Reg. § 1.754-1(a).

To the extent it is determined that a valid partnership return was not filed with the Philadelphia Service Center, a determination must be made as to whether the return was otherwise filed.

As part of T's consolidated return for Year 1 and Year 2, T included a Form 1065 for P. Because P was not part of the consolidated group, P's return was for informational purposes only. A pro forma informational return included in a consolidated return is not filed. The Form 1065 and election were signed by A, the President and Chief Executive Officer of P. Neither A nor S, of which A was an officer, was a partner of P in Year 1.

Because a Form 1065 included in a consolidated return is not considered filed, P did not satisfy the procedural requirement of filing a partnership return. Accordingly, no valid section 754 election arguably was made for Year 1. In Year 2, while the return and election were signed by an officer of S, a partner in P, P did not satisfy the procedural requirement of filing a partnership return. Accordingly, no valid section 754 election arguably was made for Year 2.

Substantial compliance with a regulation is sufficient when the regulation requires a procedural detail that does not go to the essence of the statute. If the requirement goes to the essence of the statute, it is mandatory and must be met. Young v. Commissioner, 783 F.2d 1201, 1205 (5th Cir. 1986), aff'g 83 T.C. 831 (1984); American Air Filter Co. v. Commissioner, 81 T.C. 709, 719 (1983); Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837, 846 (1978); Sperapani v. Commissioner, 42 T.C. 308, 331-32 (1964). To determine whether a regulatory provision setting forth how an election is to be made goes to the essence of the statute, and therefore must be literally complied with, the following factors are considered:

- Whether the taxpayer's failure to comply fully defeats the purpose of the statute;

- The relationship of the regulatory requirement to other provisions;
- The terms of the underlying statute;
- Whether the sanction imposed on the taxpayer for the failure is excessive and out of proportion to the default;
- Whether the taxpayer attempts to benefit from hindsight by adopting a position inconsistent with his original action or omission;
- Whether the Commissioner is prejudiced by the untimely election; and
- Whether the regulation provided with detailed specificity the manner in which an election was to be made.

American Air Filter Co., 81 T.C. at 719-20; Valdes v. Commissioner, 60 T.C. 910, 913 (1973).

The election sets forth the intent of the partnership to opt out of the usual rule governing transfers of partnership interests contained in section 743(a) in order to gain the oftentimes more favorable treatment resulting from a step-up in basis permitted under section 743(b) only by making the appropriate election. An election under section 754 commits the partnership to a position that can entail both tax benefits and tax burdens. Atlantic Veneer Corp. v. Commissioner, 812 F.2d 158, 160 (4th Cir. 1987), aff'g 85 T.C. 1075 (1985). In addition, until revoked, a valid election applies with respect to all distributions of property by the partnership and to all transfers of interests in the partnership for all subsequent taxable years. I.R.C. § 754. Thus, the requirement to file an election under section 754 goes to the essence of the statute and must be met. Accordingly, substantial compliance with the regulation is not sufficient. Rather, the procedural requirement of filing a partnership return including the election and signed by a partner is mandatory and must be met.

T may be entitled to relief under Rev. Proc. 92-85, 1992-2 C.B. 490. The Commissioner, in his discretion, may grant an extension of time to file an election under section 754. Rev. Proc. 92-85 ;Treas. Reg. § 301.9100-3(a). Under section 4, a 12-month automatic extension is granted for making a section 754 election if the taxpayer takes corrective action within 12 months of the deadline for making the election. Corrective action is filing an original or an amended return to attach the

appropriate form for making the election. Section 4.01, Rev. Proc. 92-85. Because P has not filed a return, the 12-month automatic extension is not available.

Under section 5, to qualify for an extension, a taxpayer must establish to the satisfaction of the Commissioner that he acted reasonably and in good faith and that granting the extension will not prejudice the interests of the government. Sec. 5, Rev. Proc. 92-85; Treas. Reg. § 301.9100-3(a). A taxpayer that failed to make an election, which is discovered by the Service, will be deemed to have acted reasonably and in good faith if the taxpayer:

- Inadvertently failed to make the election because of certain intervening events beyond the taxpayer's control or, because after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity of the election;

- Reasonably relied on the written advice of the Service; or

- Reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make or advise the taxpayer to make the election.

Section 5.01(2), Rev. Proc. 92-85; Treas. Reg. § 301.9100-3(b)(1). The interests of the government are prejudiced if granting relief under Rev. Proc. 92-85 would result in a taxpayer having a lower tax liability in the aggregate for all years to which the election applies than the taxpayer would have had if the election had been timely made (taking into account the time value of money). Similarly, if the tax consequences of more than one taxpayer are affected by the election, the government's interests are prejudiced if extending the time for making the election may result in the affected taxpayers, in the aggregate, having a lower tax liability than if the election had been timely made. Section 5.02(1), Rev. Proc. 92-85.

If a taxpayer can establish that he acted reasonably and in good faith, and the extension will not prejudice the interests of the government, he must comply with the procedural requirements set forth in sec. 6, Rev. Proc. 92-85. There is insufficient information to determine if P would be entitled to relief under Rev. Proc. 92-85.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:</u>

[redacted]

Please call if you have any further questions.

By: _____

PATRICK PUTZI
Special Counsel (Natural Resources)
Passthroughs & Special
Industries Branch
Field Service Division