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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Michael J. Cooper, Acting Associate Area Counsel (LMSB), Denver

FROM: David R. Haglund, Senior Technician Reviewer, Associate Chief Counsel (Passthroughs and Special Industries), CC:PSI:1

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated January 29, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110 (i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. section 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND

A	=	
B	=	
C	=	
D	=	
Partnership	=	
Seller	=	
Buyer	=	
Lender1	=	
Lender2	=	
City	=	
State 1	=	
D1	=	
D2	=	
D3	=	
D4	=	
Year1	=	
Year4	=	
Year9	=	
Year10	=	
Year11	=	
Year12	=	
Year13	=	
Year14	=	
$a	=	$
$b	=	$
$c	=	$
$d	=	$
$e	=	$
$f	=	$
$g	=	$
$h	=	$
$i	=	$
$j	=	$
$k	=	$
$m	=	$
$n	=	$
$o	=	$
$p	=	$
$q	=	$
$r	=	$
$s	=	$
$t	=	$

$u = $
$v = $
$w = $
$x = $
$y = $
$z = $
$ab = $
$ac = $
$ad = $
$ae = $
$af = $
$ag = $
$ah = $
$ai = $
$aj = $
$ak = $
$al = $
$am = $
$an = $
$ao = $
$ap = $
$aq = $
$as = $
$at = $
$av = $
$aw = $
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$az = $
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$bc = $
$bd = $
$be = $
$bf = $
$bg = $
$bh = $
$bi = $
$bj = $
$bk = $

$bl = $
$bm = $
$bn = $
$bo = $

$bp	=	$
$bq	=	$
$br	=	$
$bs	=	$
$bt	=	$
$bu	=	$
$bv	=	$
$bw	=	$
$bx	=	$
$by	=	$
$bz	=	$
$ca	=	$
$cb	=	$
$cc	=	$
$cd	=	$
$ce	=	$
$cf	=	$
$cg	=	$
$ch	=	$
$ci	=	$
$cj	=	$
$ck	=	$
$cl	=	$
$cm	=	$
$cn	=	$
$co	=	$
$cp	=	$
$cq	=	$
$cr	=	$
$cs	=	$
$ct	=	$
$cu	=	$
$cv	=	$
$cw	=	$
$cx	=	$
$cy	=	$
$cz	=	$
$da	=	$

$db	=	$
$dc	=	$
$dd	=	$
$de	=	$
$df	=	$

$dg	=	$
$dh	=	$
$di	=	$
$dj	=	$
$dk	=	$
$dl	=	$
$dm	=	$
$dn	=	$
$do	=	$
$dp	=	$
$dq	=	$
$dr	=	$
$ds	=	$
$dt	=	$
$du	=	$
$dv	=	$
$dw	=	$
$dx	=	$
$dy	=	$
$dz	=	$
$ea	=	$
$eb	=	$
$ec	=	$
$ed	=	$
$ee	=	$
$ef	=	$
$eg	=	$
$eh	=	$
$ei	=	$
$ej	=	$
$ek	=	$
$el	=	$
$em	=	$
$en	=	$
$eo	=	$
$ep	=	$
$eq	=	$

a%	=
b%	=
c%	=
d%	=
e%	=
f%	=

g% =
h% =
i% =
j% =
k% =
l% =
m% =
n% =
o% =
p% =
q% =
N1 =
N2 =
N3 =
N4 =
N5 =

ISSUES

Your incoming memorandum raises the following two questions.

1) What is the proper allocation of partnership liabilities both before and after the second loan restructuring, transfer of partnership interests by B to D, and the redemption of two partners (A and C); and

2) How must the cancellation of indebtedness (COD) income arising from the cancellation of the capitalized interest be allocated among the partners in light of the transfer by B of a% of its interest in Partnership to D and the redemption of A and C?

CONCLUSIONS

An analysis of Partnership's allocation of its liabilities should be considered before and after all three steps (the cancellation of debt, the transfer, and the redemption). Before the three steps, the liabilities of Partnership were nonrecourse and were allocated to the partners based upon their ownership percentages. After the three steps, all of the indebtedness was characterized as a recourse obligation and virtually all of it was allocated to D. Partnership's allocation of its liabilities both before and after the three steps appears to be consistent with the regulations under section 752.

The COD income as allocated by Partnership should be reallocated in accordance with each partner's interest in the partnership under § 1.704-1(b)(3) because the partnership agreement does not have the requisite safe harbor provisions

for its allocations. This reallocation would appear to be consistent with the manner in which Partnership has allocated all of its items of income, gain, loss, deduction and credit prior to Year 13.

B's transfer of the majority of its interest in Partnership to D should be viewed as a division of B that is akin to a conversion of a limited partnership to a limited liability company. The conversion has no immediate tax consequences, and the allocation of the COD income to D rather than the B is of no consequence because we view B and D as essentially the same entity.

A and C receive a deemed distribution of cash upon their withdrawal from Partnership and the tax consequences to these partners should be determined under the distribution provisions of subchapter K of the Code.

FACTS

Partnership Structure

Partnership is a State 1 limited partnership using an accrual method of accounting and a calendar year taxable year. Partnership was formed in Year1 as a rental real estate company.

On D1, Seller sold to Buyer certain real and personal property located in downtown City. Buyer paid $a for certain real and personal property. The real property consisted of a N1 story building, a N2 story building, a N3 story structure , a N4 story building, a N5 story building, and two . Buyer paid approximately $b at closing and agreed to take title to the various real property encumbered by two loans in the approximate amount of $c.[1]

On D2, Buyer assigned all of its rights and delegated all of its obligations under the agreement with Seller with respect to the N4 and N5 story buildings and one of the to Partnership (the "Property").[2] The consideration paid for the assignment was nominal. Partnership accepted the assignment and assumed, agreed to undertake to pay, perform and discharge all debts, obligations, covenants and agreements of Buyer arising out of the agreement with respect to Seller.

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[1] Buyer agreed to take title to the various properties to the extent encumbered by a loan in the amount of $d and to the extent of $e of a loan (entire principal due of $a) from Lender 1.

[2] While the incoming memorandum suggests that all of the property held by Buyer was assigned to Partnership, we did not review any documents assigning the N1, N2, or N3 story buildings or the associated with those buildings.

Partnership was formed with three partners whose initial capital contributions and interests were as follows:[3]

	Capital Contribution	Interest
General Partners		
A	$f	b%
B	$f	b%
Limited Partners		
B	$g	c%
C	$g	c%

Section 7.5 of the First Amendment and Restatement of the Limited Partnership Agreement dated D3 (hereafter "Agreement"), provides as follows with respect to the maintenance of capital accounts for each of the partners.

> (a) An individual capital account (a "Capital Account") shall be maintained for each Partner. A Partner's Capital Account shall be computed in accordance with Treasury Regulations promulgated under Section 704(b) of the Code, including without limitation, optional adjustments in connection with elections under Section 754 of the Code and, if approved by the General Partners, in-kind distributions. If the allocations and distributions required or permitted under this Agreement result in the reduction of a Partner's Capital Account, unless otherwise provided in this Agreement, such reduction need not be restored.
>
> (b) Except as may be otherwise provided in this Agreement: (i) no Partner shall be entitled to withdraw any amount on account of his Capital Account, to demand or receive any property from the Partnership other

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[3] The names of the partners, the amount of each partner's initial capital contribution, and the percentage interests in the partnership were taken from an amended and restated partnership agreement dated D3. We note that these numbers are not consistent with the percentage interests as reported on Partnership's tax returns for Year 10 through Year 14 or the incoming memorandum. The original partnership agreement was not submitted to the National Office. Regardless of whether the amended and restated partnership agreement or the tax returns (and incoming memorandum) are correct, if the aggregate ownership percentages did not change until the second restructuring, then our analysis herein is not affected.

> than cash, or to receive any interest on, or payments in respect of, his Capital Account; and (ii) no Partner shall be obligated to restore any deficit in his Capital Account or bring his Capital Account into any particular relationship with the Capital Account of any other Partner.

Section 10 of the Agreement provides that except as provided for certain special allocations to assure each partner a specified return on investment, and for allocations related to property within section 704(c) or ordinary income under sections 751, 1245, or 1250, each item of income, gain, loss, deduction or credit is to be allocated to each partner in the proportion of their respective distributive shares. If during a taxable year of the partnership, a partner's distributive share changes, the items are to be allocated on a daily basis based on the distributive share held by such partners and the number of days the interest is held, unless the general partners elect to close the books of Partnership to take into account the varying interests of the partners.

Section 14.1 of the Agreement provides that no limited partner shall have any personal liability to Partnership, to any of the partners, or to the creditors of Partnership for the debts of Partnership or any of its losses beyond the amount contributed or agreed to be contributed by the limited partner to the capital of Partnership.

It appears that from the date of formation through the date of the second restructuring on D4, discussed below, that the partners' respective ownership interests in Partnership, with respect to one other, remained unchanged.

Partnership Liabilities

Lender 1 financed the construction of the Property and held the mortgage prior to the acquisition of the Property by Partnership in Year1. Lender 1 financed Partnership's acquisition with a loan of $h, plus an $i working capital facility and a $j secondary working capital facility, for a total amount of $k.[4] No partner of Partnership is related to Lender 1. At the time of the Year1 assignment to Partnership, the Property was also encumbered by an $m liability in favor of another lender.

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[4] It appears that the loans to Partnership were used, in part, to pay off a portion of the existing indebtedness on the Property.

Pursuant to the Schedule K-1s issued to each of the partners[5], Partnership allocated its liabilities to each of the partners as follows:[6]

Liability allocation	A b% GP	B c% GP	B b% LP	C p% GP	C b% LP	D o% GP
Year10						
Q'd Nonrecourse	$p	$q	$p	$r	$p	
Other	$s	$t		$u		
Total	$v	$w	$p	$x	$p	
Year11						
Q'd Nonrecourse	$y	$z	$y	$ab	$y	
Other	$ac	$ad		$ae		
Total	$af	$ag	$y	$ah	$y	$0
Year12						
Q'd Nonrecourse	$ai	$aj	$ai	$ak	$ai	
Other	$al	$am		$an		
Total	$ao	$ap	$ai	$aq	$ai	$0
Year13						
Q'd Nonrecourse	$0	$n	$as	$0	$0	$at
Other	$0	$o		$0	$0	$av
Total	$0	$aw	$as	$0	$0	$ax
Year14						
Q'd Nonrecourse		$ay				$az
Other						$ba
Total	$0	$ay	$0	$0	$0	$bb

First Loan Restructuring

By Year4, substantial interest had accrued on the Lender 1 note and this interest, which was not paid, had been capitalized and added to the principal balance of the obligation. In Year4 the Lender1 loan was restructured. Under the

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[5] The National Office only received and reviewed Partnership's tax returns for Year 10 through Year 14. For a comprehensive review of the issues in this case, the tax returns for Year 1 through Year 9 need to be considered.

[6] The amounts listed on the Schedule K-1 for Year 13 for B with respect to its general partnership interest, as set forth in Schedule K-1, were $n and $o for qualified nonrecourse liabilities and other liabilities, respectively. These amounts appear to be incorrect because a substantial portion of B's interest was transferred to D in Year 13. Further, the amounts listed on the tax returns for B's limited partnership interest should be reviewed.

restructuring agreement, Lender 1 made the following new nonrecourse loans: one loan for $bc (hereafter "First Note") and one loan for $bd million (hereafter "Fourth Note"). Further, the original note given in Year1 was modified to an amount of $be (hereafter "Existing Note"). The First, Fourth, and Existing Note are collectively referred to as the Lender 1 notes. At the same time, Lender 2 made a loan to Partnership in the amount of $bf.[7]

The interest rate on the First and Fourth Notes was the lower of the prime rate or d%. The interest on the Existing Note varied from e% to f%. The interest rate on the Lender 2 loan was g%.

Interest on the notes was to be paid out of cash flow. Cash flow was defined as revenue plus disbursements of "Additional Facility Proceeds" (a $bg Sixth Note from Lender 1), less costs as annually budgeted.[8] Interest on the First and Fourth Note was payable from h% of aggregate cash flow. Interest on the Existing Note was payable after the payments on the First and Fourth Notes. Interest on the Lender 2 loan was payable out of i% of aggregate cash flow.

From the date of the first restructuring substantial interest accrued on each of the loans. This interest was not paid but was capitalized and added to the outstanding principal balance on the various loans. A schedule of the principal and accrued interest from the date of the first restructuring to D4, is as follows:

	Principal	Accrued Interest	Total Principal and Accrued Interest
First Note	$bc	$bh	$bi
Existing Note	$bj[9]	$bl	$bm
Third Note Lender 2	$bf	$bn	$bo
Fourth Note	$bd	$bp	$bq
Total	$br	$bs	$bt

[7] The numbering on the notes is in accord with the Loan Agreement. While the incoming memorandum states that the loan made by Lender 2 was made in Year 4, we note that it appears to have been made pursuant to a promissory note dated D2.

[8] The significance of the Fifth and Sixth notes is not clear. It should be determined whether amounts were actually transferred pursuant to these notes. The Fifth note is not referenced here, but references can be found throughout the record.

[9] The original principal amount was $be. However, a payment of $bk was made in the first half of Year 13.

Partnership accrued and deducted amounts on its tax returns as interest expense. The record suggests that the amounts deducted were never paid, but rather, were capitalized and added to the principal of the various notes. The deductions taken were in the following amounts.

Year	Interest Expense
Year 10	$bu
Year 11	$bv
Year 12	$bw
Year 13	$bx
Year 14	$by

Second Loan Restructuring

As seen from the chart above, by D4, the accrued but unpaid interest (which had been capitalized to principal) increased the total principal amounts of the notes to approximately $bz, of which approximately $ca was owed to Lender 1.

On D4, the original debt and capitalized interest exceeded the value of the properties,[10] and the debt was again restructured. At that time, Partnership acknowledged that it had no equity in the property. In the second loan restructuring, the accrued but unpaid interest on the Lender 1 notes was discharged and the original principal of the Lender 1 notes was restructured but, in the aggregate, not decreased. With respect to the Lender 2 loan, however, only $cb of the accrued interest and original principal was forgiven. The remainder of the Lender 2 loan was restructured. All of the restructured notes (both the notes outstanding to Lender 1 and the Lender 2 note) were reclassified as recourse obligations.[11]

The restructuring of the various loans was stated in three amended and restated loan agreements, referred to as the Senior Tranche, the Middle Tranche, and the Junior Tranche (collectively "the Tranches").[12] The Junior Tranche restated the Fourth, Fifth, and Existing note in an amount equal to $cc. The Middle Tranche was comprised of two notes, one restructured for portions of the Lender 1 notes and one restructured for the Lender 2 loan. With respect to the Middle Tranche restructuring

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[10] The value of the properties is not clear from the materials submitted to the National Office.

[11] Despite being reclassified in the restructuring documents as recourse obligations, Partnership's tax returns appear to have continued to report the obligations as nonrecourse.

[12] The Lender 1 notes to Partnership were restructured into the Tranches with the specific intention of selling off portions of the loans.

for the Lender 1 notes, there was a single note which restated the original principal balance of the First and Second note, and part of the principal balance of the Fourth and Fifth note in the aggregate amount of $cd. The Senior Tranche amended and restated a portion of the original principal of the First and Second note in the amount of $ce. Section 2.01 of the Middle Tranche summarizes the Tranches in part as follows:

> All indebtedness other than that now evidenced by the Senior Tranche Note, the Middle Tranche Note, the Lender 2 Middle Tranche Note and the Junior Tranche Note, is and shall be deemed discharged concurrently herewith, including, but not limited to, all accrued interest, all other charges payable with respect thereto, and all principal in excess of the principal balance of the Senior Tranche Note, the Middle Tranche Note, and the Junior Tranche Note, such that as of D4, the total aggregate indebtedness of Borrower to Lender 1 shall be ...$cf and the total aggregate indebtedness of Borrower to Lender 2...shall be $cg.

The various notes that resulted from the first restructuring in Year4, and which were restructured into the Tranches, can be summarized as follows:[13]

	Principal	Senior Tranche	Middle Tranche	Junior Tranche
First Note	$bc	$ce	$ch	
Existing Note	$bj[14]			
Third Note	$bf		$ci[15]	
Fourth Note	$bd		$cj	$cc

Also on D4, B transferred a% percent of its interest (c% of its general partnership interest and n% of its limited partnership interest) in Partnership to D, a State 1 limited liability company. B retained n% of its limited partnership interest, which was converted to a general partnership interest. On the same day, A and C ("retiring" or "redeemed" partners) withdrew from Partnership. It appears the sole

[13] The documents implementing the restructuring state that a portion of the Fifth note was restructured. However, Attachment 11 in the record, which summarizes the restructuring, does not refer to the Fifth note.

[14] The entire principal amount of the Existing Note was restructured among the Middle Tranche and Junior Tranche of the Fourth Note.

[15] This amount represents the total principal and accrued interest to the date of the second restructuring less $cb of accrued interest that was forgiven.

consideration provided to the retiring partners was relief from each partner's share of Partnership's liabilities.[16]

As a result of these transactions, D became a o% partner in Partnership and B became a b% partner. The ownership of D was identical to the ownership of B.

As a result of the second restructuring on D4, Partnership recognized COD income in the amount of $ck, which was allocated among the partners as follows:[17]

Total	A	B - GP	B - LP	C - GP	C - LP	D - GP	
$ck		$cl	$cm	$cn	$co	$cl	$cp

The COD income was allocated first to the withdrawing partners (A and C) to the extent that each of those partners had a negative balance in their respective tax capital account. Beyond this allocation, however, no income, gain, loss, or deduction of Partnership was allocated to the withdrawing partners. The allocation of the COD income was purportedly based on an interim closing of the partnership books in accordance with the rules provided by § 1.706-1(c)(2)(ii) as of the close of business on the date on which the agreement admitting D as a new general partner became effective, or D4.

The actual allocation of the COD income to A and C can be compared with each of those partner's respective share of Partnership's liabilities at the time of their redemption as follows:

	COD allocation	Liability share
A	$cl	$ao
C	$cq	$cr

Capital Accounts

[16] It needs to be determined for certain whether there was additional consideration for the withdrawal. A document admitting D as a general partner of Partnership and executing the withdrawal of A and C, states in part "As payment for the surrender of the A and C interests, after D and B collectively have received distributions...that achieve a...rate of return...the Partnership will pay the Withdrawing Partners...an amount equal to the sum of...."

[17] We note that Partnership recognized additional COD income in Year 14. The recognition of this income may not bear on the issues discussed in this document. However, it would be useful to understand the events surrounding Partnership's reporting of the COD income in Year 14.

The Agreement calls for Partnership to maintain capital accounts in accordance with the regulations under section 704(b). According to the respective Form 1065s filed for Partnership for the following years, each partner's capital account can be reconciled as follows[18]:

	A - b% GP interest	B - c% GP interest	B - b% LP interest	C - p% GP interest	C - b% LP interest	D - o% GP interest
Ending Year9	$cs	$ct	$cs	$cu	$cs	
Capital contributed						
Share of income						
Withdrawals/Distribs						
Ending Year10	$cv	$cw	$cv	$cx	$cv	
Capital contributed						
Share of income	$cy	$cz	$cy	$da	$cy	
Withdrawals/Distribs						
Ending Year11	$db	$dc	$db	$dd	$db	
Capital contributed						
Share of income	$de	$df	$de	$dg	$de	
Withdrawals/Distribs						
Ending Year12	$dh	$di	$dh	$dj	$dh	
Capital contributed			$dk			$dl[19]
Share of income	$cl	$dm	$dn	$co	$cl	$do
Withdrawals/Distribs		$dp	$dq			
Ending Year13	$0	$0	$dr	$0	$0	$ds
Capital contributed			$dt			$du
Share of income			$dv			$dw
Withdrawals/Distribs						
Ending Year14	$0	$0	$dx	$0	$0	$dy

Below is a comparison between how Partnership actually allocated the COD income, and how Partnership would have allocated the income based on the respective partner's distributive share or percentage interest in Partnership using the interim closing method under § 1.706-1(c)(2)(ii).

	Actual Allocation Of COD Income	Allocation of COD income If Based Upon Ownership Percentage
A	$cl	$dz
B -GP	$cm	$ea
B -LP	$cn	$dz

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[18] Each partner had a negative balance in their respective capital accounts as of Year 10 and no partner had a deficit restoration obligation. The Agreement does not contain a qualified income offset.

[19] It is not clear how this number is derived.

C -GP	$co	$eb
C -LP	$cl	$dz
D	$cp	-----------

Partnership allocated the remainder of its items of income, gain, loss, deduction, and credit for Year 13 as follows:

	Allocation of items For Period 1/1/Year13-D4			Allocation of items For Period D4-12/31/Year13		
	Ordinary Loss	Rental Loss	Interest Income	Ordinary Loss	Rental Loss	Interest Income
A	$0	$0	$0	$0	$0	$0
B - GP	$ec	$ed	$ee			
B - LP	$ef	$eg	$eh	$ei	$ej	$ek
C - GP	$0	$0	$0	$0	$0	$0
C - LP	$0	$0	$0	$0	$0	$0
D - GP	$el	$em	$en	$eo	$ep	$eq

For Year10 through Year 12, Partnership allocated all of its items of income, gain, loss, deduction and credit (as well as Partnership liabilities) in accordance with each partner's respective distributive share or percentage interest in Partnership.

Question 1. What is the proper allocation of liabilities both before and after the loan restructuring and redemption of A and C?

LAW:

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

Section 752(d) provides that in the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships. Section 1001-2 provides that the amount realized from a sale or other disposition of property includes

the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. See § 1001-2(c) Ex. 3.

Section 1.752-1[20] provides that a liability is considered a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under § 1.752-2. A liability is considered nonrecourse to the extent that no partner or related person bears the economic risk of loss for that liability under § 1.752-2.

Section 1.752-2 provides that a partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss. Under § 1.752-2(b) a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. Upon a constructive liquidation, all of the following events are deemed to occur simultaneously:

(i) All of the partnership's liabilities become payable in full;

(ii) With the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero;

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[20] The original liabilities in this case were incurred at the time Partnership acquired the Property, and were first restructured in Year 4. At the time Partnership acquired the Property, then § 1.752-1(e) provided that where none of the partners of a partnership have any personal liability with respect to a partnership liability, then all partners, including limited partners, shall share such liability under § 752(c) in the same proportion as they share the profits. Partnership appears to have allocated the nonrecourse liabilities consistent with this older regulation. TD 8237, 1989-1 C.B. 180, set forth temporary regulations under § 752 that are substantially similar to the current regulations. However, absent an election, the temporary regulations applied only to liabilities incurred or assumed by a partnership on or after January 30, 1989. The temporary regulations were replaced by the current regulations. Absent an election, the current regulations (as promulgated in TD 8380, 1992-1 C.B. 218) under § 752 apply only to liabilities incurred or assumed by a partnership on or after December 28, 1991. See § 1.752-5. Assuming the capitalization of each unpaid interest accrual is proper and gives rise to a new nonrecourse liability that is subject to the regulations then applicable, the facts in this case do not suggest that a different allocation of the liability would occur because all of Partnership's allocations were made according to each partner's respective percentage interest in Partnership.

(iii) The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership);

(iv) All items of income, gain, loss, or deduction are allocated among the partners; and

(v) The partnership liquidates.

Section 1.752-3 provides that a partner's share of the nonrecourse liabilities of a partnership equals the sum of (1) the partner's share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder; (2) the amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; and (3) the partner's share of the excess nonrecourse liabilities (those not allocated under (1) and (2)) of the partnership as determined in accordance with the partner's share of partnership profits. The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under section 704(b)) of some other significant item of partnership income or gain. Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated.

Section 1.752-4(a) provides that an upper-tier partnership's share of the liabilities of a lower-tier partnership (other than any liability of the lower-tier partnership that is owed to the upper-tier partnership) is treated as a liability of the upper-tier partnership for purposes of applying section 752 and the regulations thereunder to the partners of the upper-tier partnership.

ANALYSIS:

This case involves three transactions (sometimes referred to as steps) in which a portion of the outstanding indebtedness owed by Partnership is forgiven, the interests in Partnership (which is a lower-tier partnership of the transferor) are transferred to a new partner (which is an upper-tier partnership), and two partners are redeemed. We conclude that the three transactions must be viewed together, considering the liability allocation before and after the completion of the integrated steps. We also conclude that the events occur in the following order, one right after

the other: 1) the indebtedness is forgiven, 2) the upper-tier partnership, B, transfers a large portion of its interest to another partnership, D, that has identical ownership to B, and 3) the partners are redeemed.[21]

When the interest is accrued and capitalized (added to principal), the interest becomes a partnership liability, and the liability must be allocated among the partners. Nothing suggests that the capitalized interest should be allocated in a manner different than the original principal. When the principal and capitalized interest are allocated among the partners, each partner who is allocated a share of the liability is deemed to have made a cash contribution to Partnership under section 752(a). This deemed cash contribution increases the partner's basis in his partnership interest.

Partnership appears to have set forth an allocation regime whereby each partner's respective share of any item from the Partnership is equal to such partner's percentage interest in Partnership. A partner's percentage interest in Partnership is determined by the capital contributions made by the partner at the inception of the partnership. In other words, prior to the second restructuring, Partnership appears to have a straightforward allocation system in place with no special allocations to any of the partners.

Prior to the second restructuring, all of the outstanding indebtedness to Lender 1 and Lender 2 is considered nonrecourse because no partner or related person bears the economic risk of loss for these liabilities. Further, Partnership's allocation of the nonrecourse liabilities prior the second restructuring appears to be consistent with the straightforward allocation system in that each partner was allocated a portion of the liability that was consistent with each partner's interest in all other items of Partnership. Whether the allocation was based upon the first tier (allocate to partner to the extent of such partner's share of partnership minimum gain) or third tier (allocate in accordance with the manner in which partnership profits are allocated) of § 1.752-3 does not appear to result in a different conclusion because Partnership appears to have allocated all items of income, gain, deduction, loss and credit prior to the second restructuring based upon the ownership percentages of the partners. Therefore, it appears that Partnership's allocation of the nonrecourse liability among the partners is consistent with the regulations under § 1.752-3.

The upper-tier partnership (B) then transfers a large portion of its interest to another partnership (D) who has an identical ownership structure. Further, two partners (A and C) are redeemed from Partnership. The liabilities of the lower-tier

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[21] It is rather clear that the COD income was recognized before A and C withdrew from Partnership. We base this conclusion, in part, on the fact that Partnership closed its books upon the withdrawal of A and C and allocated COD income to them. Further, the transfer by the upper-tier partnership, B, to D, appears to have occurred an instant before the withdrawal of A and C.

partnership (Partnership) have already been restructured at this point and have been converted to recourse obligations. After the transfer of the interests to the limited liability company, the conversion of the retained portion of B's interest in Partnership to a general partnership interest, and the redemption of A and C, the two partners in Partnership are the transferor partnership (B) and its related partnership (D). B is a b% general partner, and D is a q% general partner and a b% limited partner.

Since the restructured indebtedness is now a recourse obligation of Partnership, it must be determined how the partners bear the economic risk of loss with respect to the liabilities. Both partners are general partners. However, the partners have differing percentage interests as general partners which dictate different allocations with respect to losses. B has a b% general partnership interest and will be allocated b% of all items of income, gain, loss, and deduction. Similarly, D has a q% general partnership interest which will entitle it to be allocated q% of all of the partnership's income, gain, loss, and deduction items. At this point, if a constructive liquidation of Partnership is conducted in accordance with § 1.752-2, it appears the parties will bear the burden of the recourse obligation unequally; D will essentially bear all of the burden with respect to the recourse obligation of Partnership. Accordingly, D will be allocated virtually all of the recourse liability after the restructuring. See § 1.752-2(f) Ex. 2.

Although before the restructuring, B had approximately a k% share of Partnership's nonrecourse liabilities, and after the restructuring its share has been reduced to approximately b%, we conclude that B should not be deemed to have a cash distribution under section 752(b) such that it must recognize gain. Our conclusion is based upon the fact that what has occurred between B and D is a partnership division in which both resulting partnerships have identical ownership to the divided partnership. See § 1.708-1(d). In such a circumstance, the liability shift between the partnerships should not cause one or the other to recognize gain where the ultimate partners of the divided upper-tier partnership have merely exchanged portions of their respective interest in a limited partnership for interests in a limited liability company. See Rev. Rul. 95-37, 1995-1 C.B. 130. This conclusion is buttressed by § 1.752-4 which treats an upper-tier partnership's share of a lower-tier partnership's liabilities as the liabilities of the upper-tier partnership for purposes of applying section 752 to the partners of the upper-tier partnership. Therefore, we conclude that Partnership's allocation of the outstanding liabilities before and after the second restructuring appear to be in accordance with the regulations under section 752.

Question2. How must the COD income arising from the cancellation of the capitalized interest income be allocated among the partners in light of the the transfer by B of o% of its interest in Partnership to D and the redemption of A and C?

LAW:

1. Allocations - in general

<u>Section 704(b)</u>

Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (PIP), (determined by taking into account all facts and circumstances), if:

(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof); or

(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Section 1.704-1(b)(1)(i) provides that if the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit to a partner, there are three ways in which the allocation will be respected under section 704(b). First, the allocation can have substantial economic effect in accordance with §1.704-1(b)(2). Second, taking into account all facts and circumstances, the allocation can be in accordance with the partner's interest in the partnership (§ 1.704-1(b)(3)). Third, the allocation can be deemed to be in accordance with the partner's interest in the partnership pursuant to the special rules in § 1.704-1(b)(4) and § 1.704-2. To the extent an allocation under the partnership agreement of income, gain, loss, deduction, or credit to a partner does not have substantial economic effect, is not in accordance with the partner's interest in the partnership, and is not deemed to be in accordance with the partner's interest in the partnership, such income, gain, loss, deduction, or credit will be reallocated in accordance with the partner's interest in the partnership (§ 1.704-1(b)(3)).

A. Substantial economic effect.

To have substantial economic effect, partnership allocations must reflect the actual division of income or loss among the partners when viewed from the standpoint of economic, rather than tax, consequences. <u>Goldfine v. Commissioner</u>, 80 T.C. 843 (1983). Section 1.704-1(b)(2)(i) provides that the determination of whether an allocation of income, gain, loss, or deduction to a partner has substantial economic effect involves a two-part analysis that is made as of the end of the partnership taxable year to which the allocation relates. First, the allocation must have economic effect within the meaning of §1.704-1(b)(2)(ii). Second, the economic effect of the allocation must be substantial within the meaning of §1.704-1(b)(2)(iii). If an allocation does not have economic effect within the meaning of §1.704-1(b)(2)(ii), one does not have to reach the second step of the analysis.

Section 1.704-1(b)(2)(ii)(a) provides that in order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. In other words, if there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden. For a partnership's allocations to have economic effect, the partnership agreement generally must meet three mechanical requirements §1.704-1(b)(2)(ii)(b) (the "safe-harbor" test). The partnership agreement must provide: 1) for the determination and maintenance of the partners' capital accounts in accordance with the rules of §1.704-1(b)(2)(iv); 2) that upon the liquidation of the partnership (or of any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after making all capital account adjustments of the partnership taxable year during which such liquidation occurs; and 3) if a partner has a deficit balance in the partner's capital account following the liquidation of the partner's interest in the partnership, the partner is unconditionally obligated to restore the amount of the deficit. If a partnership satisfies each of these requirements, its allocations are generally treated as having economic effect for tax purposes.

Section 1.704-1(b)(2)(ii)(i) provides that allocations that do not meet the "safe-harbor" requirements of §1.704-1(b)(2)(ii)(b) will nevertheless be deemed to have economic effect if, as of the end of each taxable year, a liquidation of the partnership at the end of such taxable year (or at the end of any future year) would produce the same economic results to the partners as would occur if the requirements of §1.704-1(b)(2)(ii)(b) had been satisfied, regardless of the economic performance of the partnership.

B. Partner's Interest in the Partnership (PIP)

A partner's interest in the partnership and the partner's interest in any particular item of partnership income, gain, or loss are generally determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. Section 1.704-1(b)(3) sets forth a presumption that all partners have equal interests in the partnership, determined on a per capita basis. Therefore, in this case, A, B, and C are each presumed to each have approximately a 33% interest in Partnership.

Either the taxpayer or the Service may rebut this presumption by establishing facts and circumstances which show that the partners' interests in the partnership were not equal. Any and all facts relating to the partners' underlying economic agreement will affect the determination of a partner's interest in the partnership. Section 1.704-1(b)(3)(ii) provides that the following facts and circumstances are ordinarily taken into account for purposes of determining PIP or a partner's interest in any particular item of income, gain, or loss:

(1) the partners' relative contributions to the partnership;
(2) the partners' interests in the economic profits and losses (if different than that in taxable income and loss);
(3) the interests of the partners in cash flow and other non-liquidating distributions; and
(4) the rights of the partners to distributions of capital upon liquidation.

2. Allocation of nonrecourse deductions[22]

Section 1.704-2(b) provides that allocations of losses, deductions, or section 705(a)(2)(B) expenditures attributable to partnership nonrecourse liabilities ("nonrecourse deductions") cannot have economic effect because the creditor alone bears any economic burden that corresponds to those allocations. Thus, nonrecourse deductions must be allocated in accordance with the partner's interests in the partnership. Section 1.704-2(e) provides a "safe-harbor" test that deems allocations of nonrecourse deductions to be in accordance with the partner's interests in the partnership. If the "safe-harbor" is not satisfied, however, the partners' distributive shares of nonrecourse deductions are determined under § 1.704-1(b)(3), according to the partners' overall economic interests in the partnership.

The safe-harbor of § 1.704-2(e) provides that allocation of nonrecourse deductions are deemed to be in accordance with the partners' interests in the partnership only if:

1. Throughout the full term of the partnership requirements (1) and (2) of § 1.704-1(b)(2)(ii)(b) are satisfied and requirement (3) of either § 1.704-1(b)(2)(ii)(b) or § 1.704-1(b)(2)(ii)(d) is satisfied (i.e., partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset);
2. Beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities;
3. Beginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a

[22] Citations to the regulations addressing the allocation of nonrecourse deductions (and allocations resulting from decreases in partnership minimum gain), and in particular, the safe harbor that applies for purposes of those allocations, are made to the current regulations under § 1.704-2. Essentially the same requirements can be found in former § 1.704-1(b)(4)(iv) (TD 8099, 1986-2 C.B. 84).

nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the minimum gain chargeback requirement of § 1.704-2 (f); and

4. All other material allocations and capital account adjustments under the partnership agreement are recognized under section 1.704-1(b) (without regard to whether allocations of adjusted tax basis and amount realized under section 613A(c)(7)(D) are recognized under § 1.704-1(b)(4)(v)).

Section 1.704-1(b)(2)(ii)(d)(6) provides that the partnership agreement contains a "qualified income offset" if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in § 1.704-1(b)(2)(ii)(d)(4), (5), or (6), will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Allocations of items of income and gain made pursuant to the preceding sentence are deemed to be made in accordance with the partners' interests in the partnership if requirements (1) and (2) of § 1.704-1(b)(2)(ii)(b) are satisfied.

3. Allocations resulting from decrease in partnership minimum gain

Partnership minimum gain decreases as reductions occur in the amount by which the nonrecourse liability exceeds the adjusted tax basis of the property encumbered by the liability. Allocations of gain attributable to a decrease in partnership minimum gain (a "minimum gain chargeback," as required under § 1.704-2(f)) cannot have economic effect because the gain merely offsets nonrecourse deductions previously claimed by the partnership. Section 1.704-2(f)(1) provides that if there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner's share of the net decrease in partnership minimum gain. Thus, to avoid impairing the economic effect of other allocations, allocations pursuant to a minimum gain chargeback must be made to the partners that either were allocated nonrecourse deductions or received distributions of proceeds attributable to nonrecourse borrowing. Section 1.704-2(e) provides a test that, if met, deems allocations of partnership income pursuant to a minimum gain chargeback to be in accordance with the partners' interests in the partnership.

ANALYSIS:

The focus of this case involves the allocation of the COD income among the various continuing and retiring partners. The Agreement does not have a minimum gain chargeback provision so the minimum gain chargeback provisions under § 1.704-2 do not apply to the allocation of the COD income. In addition, no partner in Partnership has a deficit restoration obligation, and the Agreement does not have a

qualified income offset, so no allocation would have economic effect because the allocation would not increase or decrease a deficit capital account that the respective partner would be obligated to restore. Because Partnership's Agreement does not meet the safe harbor provisions under § 1.704-2 for allocating nonrecourse deductions to its partners, Partnership's allocations must be made in accordance with each partner's interest in the partnership pursuant to § 1.704-1(b)(3). Accordingly, we conclude that the COD income must also be allocated in accordance with § 1.704-1(b)(3).[23]

It seems that each of the partner's have been allocated nonrecourse deductions over the life of Partnership. These nonrecourse deductions appear to arise from the increase in the indebtedness each year due to the capitalization of the accrued but unpaid interest, as well as from the depreciation deductions on the various properties. These deductions appear to have been allocated to each of the partners based upon their respective ownership percentages in Partnership. The original allocation of the nonrecourse deductions is respected if it is in accordance with the partner's interest in the partnership. From an analysis of the record, it appears that each partner's respective interest in Partnership for purposes of § 1.704-1(b)(3) corresponds to each partner's capital contribution to Partnership.[24] However, the field may wish to review taxpayer's returns for years prior to Year 10 to determine whether Partnership's allocations were made in accordance with each partner's percentage interest in Partnership.

Other tax consequences

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[23] We note that the same result would be reached had Partnership met the safe harbor requirements by having a minimum gain chargeback requirement in the Agreement. In that instance, the minimum gain chargeback requirement of the regulations under section 704 would require that any decrease in partnership minimum gain be allocated to the respective partners in accordance with each partner's share of the decrease. Because each of the nonrecourse deductions were allocated in accordance with what appears to us to be each partner's interest in the partnership, the COD chargeback would also have been allocated in this manner.

[24] The partners appear to have shared the economic profits and losses over the years of Partnership based upon the percentage interests of each partner. Further, each partner's rights to cash flow appear to be determined by each partner's percentage interest in Partnership. Partnership appears to have followed these percentage interests in all of its allocations since the inception of Partnership. After consideration of all the facts and circumstances, the presumption regarding equal interests for each partner's interest in Partnership appears to be overcome and each partner's interest in the partnership for purposes of § 1.704-1(b)(3) corresponds to each partner's percentage interest in Partnership.

1. A and C withdrawal from Partnership

LAW:

Section 731 provides that in the case of a distribution by a partnership to a partner, gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and that any gain so recognized shall be considered as gain from the sale or exchange of the partnership interest of the distributee partner.

Section 736(a) provides that payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in section 736(b) be considered as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership. Section 736(b) provides that payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in section 736(b)(2)) are determined, under regulations prescribed by the Secretary, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under section 736(a). Section 736(a) applies only where payments are made to a retiring general partner for the partner's share of unrealized receivables and unstated goodwill in a partnership where capital is not a material income producing factor.

Section 751(b) provides that to the extent a partner receives in a distribution partnership property which is unrealized receivables or inventory items which have appreciated substantially in value in exchange for all or a part of his interest in other partnership property (including money), or (B) partnership property (including money) other than property described in section 751(b)(1)(A)(i) or (ii) in exchange for all or a part of his interest in the partnership's unrealized receivables or substantially appreciated inventory, such transactions shall, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

ANALYSIS:

Each of the retiring partners must consider the extent that they are relieved of their respective shares of Partnership's liabilities. To the extent of each retiring partner's relief from Partnership's liabilities, each retiring partner has a deemed cash distribution. The deemed cash distribution appears to be the only consideration transferred to the retiring partners. This distribution should be considered under section 736(b) and section 731 and will reduce each retiring partner's basis in their partnership interest (the allocation of the COD income will have first increased each

retiring partner's basis). We have set forth a chart which reflects the actual allocation of COD income (and basis increase), and the liability relief (and deemed cash distribution and basis decrease), for each of the retiring partners. Further, the Admission and Redemption document suggests that A and C were to receive distributions of cash in exchange for their withdrawal from Partnership. If these payments were made, they must also be considered. Because capital does appear to be a material income producing factor for Partnership, section 736(a) does not need to be considered. However, because each of the retiring partners is receiving only cash for their respective interests in Partnership, section 751(b) must be considered.

2. B's transfer to D

LAW AND ANALYSIS:

We view B and D as, essentially, one and the same entity. The identical ownership of the two entities and B's transfer of o% of its interest in Partnership to D results in a partnership division. Even though this division causes two entities to exist at the end of the day, because the entities have identical ownership, we view the transaction as akin to a conversion of a limited partnership to a limited liability company. We limit our opinion on this matter strictly to the facts presented in this case where the ownership of the divided and resulting partnerships are identical.

The division of B is a tax-free transaction with a large part of B's share of the liabilities being allocated to D after the three steps. Section 1.752-4(a) discusses the allocation of partnership liabilities in a tiered-partnership arrangement. Here, B has a share of Partnership's liabilities before the second restructuring. In applying the above regulation for purposes of considering section 752 with respect to B's partners, B's share of the liabilities of Partnership are considered to be B's liabilities. Similarly, after the transfer of B's interests to D, which is partnership division in accordance with § 1.708-1(d),[25] D has a share of Partnership's liabilities. Again, for purposes of applying section 752 to the partners of B and D, the liabilities of Partnership are considered to be the actual liabilities of B and D. Because B and D have identical ownership, the partners of B and D, while realizing relief of liabilities from B, will have a corresponding increase of the liabilities through D. These decreases and increases appear to us to exactly cancel out each other and the net result is that the partners of B and D have merely changed the entity through which each of them has a share of the outstanding indebtedness. Accordingly, B would not recognize gain under section 752 as a result of the transfer of its interests to D.

Case Development, Hazards and Other Considerations

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[25] We note that while the current regulations addressing partnership divisions do not apply to the division in this case, the assets-over form utilized by B would appear to be respected under prior law.

CAVEAT:

This advice is limited to the particular facts of this case and does not represent a final statement of the Service's position. It may not be used, cited or relied on as precedent.

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