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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Associate Area Counsel (LMSB), Miami, Florida

FROM: Associate Chief Counsel
Passthroughs and Special Industries, CC:PSI

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated February 8, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

LEGEND:

A =
B =
C =
D =
X =
Y =
Z =
State 1 =
State 2 =
State 3 =
Notes =
Year 1 =
Year 2 =
Year 3 =
Date 1 =
Date 2 =
$a =
$b =
$c =

$d =

ISSUE:

1. Whether $a of $b Notes, executed in Date 1 are properly attributable to A?

2. Whether there is a deemed cash distribution of $a to the partners of A under I.R.C section 752(b).

CONCLUSION:

1. $a of the $b notes may be attributable to B instead of A.

2. If the $a of the $b Notes are not properly attributable to A and are attributable to B, there is a deemed dividend paid by B to B's shareholders followed by a deemed contribution to A and A's repayment of A's portion of the liability. Alternatively, there is a deemed distribution of $a from A to the partners of A under section 752(b).

FACTS:

This case involves two related entities, each owned in the same proportion by X, Y, and Z. X, Y, and Z own all of the outstanding equity interests of A, a general partnership formed under the laws of State 1, and B, an S corporation incorporated in State 2. From Year 1 through Year 2 A and B borrowed funds jointly and severally on a nonrecourse basis, pledging all of the assets of A and B, and the stock of B, as collateral for the loans. The majority of this debt was attributed to A. For purposes of this document we are assuming that the financing from Year 1 through Year 2 was properly allocated to both A and B in the proportion reported on the taxpayers' returns. No inference should be taken as to whether this treatment was actually proper.

On Date 2 A's and B's debt equaled $c. Of this amount $a was attributed to A and $d was attributed to B. In Year 3, B and C formed D, an LLC formed under the laws of State 3. In order for B to contribute its assets to D free and clear of liens, A and B refinanced the bank debt secured by A's and B's assets and the stock of B. The refinancing consisted of $b Notes, as security for Notes, B pledged its preferred interest in D as collateral, according to the facts as submitted, no other property was pledged as collateral for this debt.

LAW AND ANALYSIS:

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 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.

In the present case, the outside bases of X, Y, and Z, in A, were increased as a result of the initial borrowing attributed to A. Thus X, Y, and Z were able to receive distributions from A, tax free, to the extent of their respective bases in A.

It is well settled that the economic substance of transactions, rather than their form, governs for tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935). Courts will respect the taxpayer's characterization of the transactions if there is a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities, imbued with tax-independent considerations, and not shaped primarily by tax avoidance features that have meaningless labels attached. See Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990).

We assume, for purposes of this document, that the original financing was properly allocated between A and B. When this debt was refinanced in Year 3, the facts state that the new financing, Notes, was secured by only B's preferred interest in D, and that neither A, nor A's partners X, Y, and Z, pledged any of their assets to secure Notes and that the holders of Notes could not proceed against A or X, Y, and Z, in their individual capacities, for repayment on Notes. Thus, although the refinancing of the original debt, in form, was made to A and B, it was made solely on the basis of its being wholly collateralized by an asset belonging to B. Hence, in reality, it was B and not A which was the true borrower of such loan. Estate of Helliwell v. Commissioner, 77 T.C. 964, 987 (1981) (citing In Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), affg. 44 T.C. 284 (1965), cert. denied

385 U.S. 1005 (1967). If neither A nor A's partners X, Y, and Z pledged any of their assets to secure Notes then no portion of Notes is properly attributable to A. In that case the allocation of $a of $b Notes to A would lack economic substance and would not be respected for federal tax purposes. The $a of the $b Notes, therefore, would properly be attributed to B as the sole borrower.

As a general rule, the assumption of a shareholder liability by a corporation is considered the equivalent of a payment of cash to the shareholder. United States v. Hendler, 303 U.S. 564, reh'g denied, 304 U.S. 588 (1938); Rev. Rul. 78-422, 1978-2 C.B. 129; and sections 357(b) and 358(d)(1).

If B has assumed an obligation of A, B would be deemed to distribute $a to its shareholders, X, Y, and Z, as a dividend, which X, Y, and Z would then be deemed to contribute to A to satisfy the original financing. Alternatively, X, Y, and Z could be viewed as receiving a distribution of $a from A under section 752(b) as a result of the decrease in the partner's share of partnership liabilities.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

[redacted]

Please call Horace Howells at (202) 622-3050 if you have any further questions.

ASSOCIATE CHIEF COUNSEL
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