



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  
SPECIAL LITIGATION ATTORNEY

FROM: Deborah Butler  
Assistant Chief Counsel (Field Service) CC;DOM:FS:CORP

SUBJECT: LIQUIDATION OF SUBSIDIARY

This Field Service Advice responds to your memorandum dated May 3, 2000. 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

Holding Company A	=	
Holding Company B	=	
Original Partner A	=	
Original Partner B	=	
the Partnership	=	
#a	=	
#b	=	
Date 1	=	
Date 2	=	
Purchaser Company	=	

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Operating Company	=	
Merger Sub 2	=	
Merger Sub 1	=	
Date 3	=	
#c	=	
#d	=	
#e	=	
Partner A	=	
Partner B	=	
#f	=	
#g	=	
#h	=	
Date 4		
#i	=	

ISSUE

1. Whether Partner B should recognize any gain upon the merger of the Partnership, which is owned by Partners B and A, into Partner A.

CONCLUSION

1. Partner B will not recognize any gain upon the merger of the Partnership into Partner A because the transaction did not result in a deemed cash distribution in excess of Partner B's adjusted basis in the Partnership under section 731(a)(1)(A).

FACTS

The subsidiaries of two unrelated holding companies ("Holding Company A and Holding Company B") were the general and limited partners ("Original Partner A" and "Original Partner B") of a partnership (the "Partnership").

Original Partner A owned general and limited partnership interests entitling Original Partner A to approximately #a percent of the interests in capital and profits of the Partnership. Original Partner B owned general and limited partnership interests

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entitling Original Partner B to approximately #b percent of the capital and profits of the Partnership. At the time of the transactions, the Original Partners had deficit capital accounts in the Partnership. It has been represented that these deficit capital accounts were the result of adjustments to these capital accounts for depreciation. The Original Partners' bases in their interest in the Partnership was greater than the amount of cash held by the Partnership.

In Date 1, an investor group was formed for the purposes of acquiring the Partnership's business. This investor group acquired the Partnership's business through the following transactions.

The following events occurred prior to Date 2. First, the investor group formed a purchasing holding company ("Purchaser Company"). Purchaser Company formed an operating company ("Operating Company"). Operating Company formed a wholly-owned subsidiary (Merger Sub 2). Merger Sub 2 formed a wholly-owned subsidiary (Merger Sub 1). Second, on Date 3, Merger Sub 1 and Merger Sub 2 entered into a merger agreement with Holding Companies.

The following events occurred on Date 2. First, Original Partner A merged into Holding Company A, with the Holding Company A surviving and Original Partner B merged into its Holding Company B, with the Holding Company B surviving. The partnership interests held by Original Partner A and Original Partner B were transferred by operation of law to each Holding Company, respectively.

Second, the Partnership executed an Amended and Restated Limited Partnership Agreement ("Partnership Agreement"). #c of the Partnership Agreement provided that Holding Company B was not required to restore its deficit capital account upon the dissolution of the Partnership if the Partnership's assets were sufficient to satisfy all of the liabilities of the Partnership. #d of the Partnership Agreement provided that no partner had an obligation to restore a deficit balance in its capital account except as provided in #c and #e of the Partnership Agreement. The relevant provisions of #c of the Partnership Agreement provide as follows:

If, on dissolution and winding up of the Partnership, the assets of the Partnership are not sufficient to satisfy all of the liabilities of the Partnership, (i) [Holding Company B] shall make a contribution to the capital of the Partnership in an amount equal to the greater of (A) any unpaid balance of the [Holding Company B] Share of Partnership Debt after the Partnership's business is wound up and all of its assets applied in payment of its liabilities, or (B) any negative balance in [Holding Company B]'s Capital Account (determined after making all adjustments thereto for allocations of profit and loss and distributions for the year of termination), and (ii) [Holding Company A] shall make a contribution to the capital of the Partnership in an amount equal to the

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greater of (A) any unpaid balance of the [Holding Company A] Share of Partnership Debt after the Partnership's business is wound up and all of its assets applied in payment of its liabilities, or (B) any negative balance in [Holding Company A]'s Capital Account (determined after making all adjustments thereto for allocations of profit and loss and distributions for the year of termination).

#e of the Partnership Agreement provides as follows:

[Holding Company A] shall indemnify and hold [Holding Company B] harmless from and against any loss, cost, damage or expense incurred by [Holding Company B] arising out of or connected with [Holding Company A]'s failure to pay the [Holding Company A] Share of Partnership Debt or satisfy its obligations under #c hereof, and [Holding Company B] shall indemnify and hold [Holding Company A] harmless from and against any loss, cost, damage or expense incurred by [Holding Company A] arising out of or connected with [Holding Company B]'s failure to pay the [Holding Company B] Share of Partnership Debt or satisfy its obligations under #c hereof. This #e shall be enforceable only against the indemnifying Partner by the Indemnified Partner and shall not result in the imposition of any liability whatsoever on any Affiliate of the indemnifying Partner.

#d of the Partnership Agreement provides as follows:

Except as otherwise provided in #c and #e hereof, no Partner with a deficit balance in its Capital Account shall have any obligation to the Partnership or any other Partner to restore said deficit balance. In addition, no partner or other equity owner of any Partner shall have any liability to the Partnership or to any Partner for any deficit balance in such partner's or equity owner's capital account in the Partnership in which it is a partner or equity owner. Furthermore, a deficit Capital Account of a Partner (or of a partner or other equity owner of a Partner) shall not be deemed to be a liability of such Partner (or of such equity owner or Partner) or an asset or property of the Partnership (or any Partner). Except as otherwise provided in #e hereof, the Partners shall look solely to the assets of the Partnership for the return of their contribution.

Third, Merger Sub 2 merged into Holding Company A which was renamed Partner A and Merger Sub 1 merged into Holding Company B ("Partner B"). After the mergers, Partner A owned all of the stock in Partner B. In addition, Operating Company merged into Purchaser Company.

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Fourth, the Partnership entered into an Amended and Restated Credit Agreement (“Credit Agreement”) pursuant to which the Partnership borrowed #f (“Loan”). The Loan proceeds were distributed to the Partnership. This Credit Agreement was guaranteed by Purchaser Company, Partner A and Partner B. In addition, the Purchaser Company issued stock to investors in exchange for #g. The Partnership then used the proceeds of the Loan to refinance its existing debts and to make distributions of #h to Partner A and #i to Partner B.

Fifth, the proceeds from the distributions to Partner A and Partner B and the issuance of stock in Purchaser Company were used to pay the original stockholders of Partner A and Partner B (the Holding Companies) for the shares they surrendered in the mergers. The consideration paid to each stockholder was based on the fair market value of the Partnership’s assets, less the Partnership’s liabilities.

Sixth, Partner B adopted a complete plan of liquidation (“Plan”) into Partner A. In conjunction with the Plan, Partner B adopted a resolution that Partnership would merge into Partner A under state law.

Finally, the following events occurred on Date 4. Partnership merged into Partner A under state law. Immediately thereafter, Partner B liquidated into Partner A. The companies remaining at the conclusion of these transactions were Purchaser Company and Partner A, the wholly-owned subsidiary of Purchaser Company.

## LAW AND ANALYSIS

### LAW

Section 708(b)(1)(A) of the Internal Revenue Code (I.R.C.) provides that a partnership shall be considered terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners. Section 731(a)(1) provides that in the case of a distribution by a partnership to a partner, gain shall not be recognized to the partner, except to the extent that any money distributed exceeds the adjusted basis of the partner’s interest in the partnership immediately before the distribution.

Under section 752(a), any increase in a partner’s share of partnership liabilities, or any increase in a partner’s individual liabilities by reason of the partner’s assumption of partnership liabilities, is considered as a contribution of money by the partner to the partnership. Under section 752(b), any decrease in a partner’s share of partnership liabilities is considered as a distribution of money to the partner by the partnership. Treas. Reg. § 1.752-1(f) provides that if, as a result of a single transaction, a partner incurs both an increase in the partner’s share of the partnership liabilities (or the partner’s individual liabilities) and a decrease in the

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partner's share of partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership, and only the net increase is treated as a contribution of money to the partnership.

#### ANALYSIS-Issue 1-partnership merger

The facts support the conclusion that the Loan is a liability for purposes of section 752. In Rev. Rul. 88-77, 1988-2 C.B. 128, the Service ruled that the term "liabilities of a partnership" for purposes of section 752 includes an obligation if and to the extent that incurring the liability creates or increases the basis to the partnership of any of the partnership assets (including cash attributable to borrowings). In this case, the cash attributable to the Loan creates or increases the basis to the Partnership of its partnership assets and, accordingly, the Loan is a liability of the Partnership for purposes of section 752.

The Loan resulted in both an increase and decrease in the partners' bases in their partnership interest. The decrease in Partner B's share of Partnership liabilities under section 752(b) was offset by the increase in Partner B's individual liabilities under section 752(a). See Treas. Reg. § 1.752-1(f). There was no net decrease in Partner B's share of Partnership liabilities and, accordingly, no deemed cash distribution to Partner B. Since, on these facts, there was no deemed cash distribution, there is no gain to be recognized by Partner B under section 731(a)(1)(A) which requires a cash distribution in excess of a partners' adjusted basis in its partnership interest immediately before the distribution in order to trigger gain to the partner.

Further, the fact that Partner B's capital account had a deficit due to adjustments for depreciation does not alter this conclusion. The mere existence of a deficit capital account is not sufficient to establish the creation of a liability of the partner with the deficit. See Rev. Rul. 73-301, 1973-2 C.B. 215 (clarifying Rev. Rul. 57-318, 1957-2 C.B. 362). As in Rev. Rul. 73-301, Partner B was not under any unconditional or legally enforceable obligation that required it to repay any amounts withdrawn from the Partnership on or before a determinable date. Thus, Partner B was not relieved of any liability with respect to the deficit. This case is distinguishable from other cases, such as La Rue v. Commissioner, 90 T.C. 465 (1988) (where one partner was treated as receiving a constructive distribution under section 752(b) when the partnership transferred property subject to liabilities to another party) and Stilwell v. Commissioner, 46 T.C. 247 (1966) (where one partner was treated as receiving a constructive distribution of money under section 752(b) when the other partner assumed all partnership liabilities).

In conclusion, Partner B should not recognize any gain under section 731(a)(1)(A) upon the merger of the Partnership into Partner A because the transaction did not

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result in a deemed cash distribution in excess of Partner B's adjusted basis in the Partnership.

Please call if you have any further questions.

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