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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, NORTH CENTRAL DISTRICT, ST.
PAUL
CC:MSR:NCE:STP

FROM: Associate Chief Counsel (Passthroughs and Special
Industries)

SUBJECT: Deductions Limited to Amount at Risk

This Field Service Advice responds to your memorandum dated April 18, 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.

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LEGEND

X =

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Y =
 Z =
 G =
 N =
 Yr1 =
 D1 =
 D2 =
 D3 =
 D4 =
 D5 =

ISSUES

Whether solvent limited partners who recognize cancellation of indebtedness income at the partner level are prevented from claiming partnership losses as a result of the at-risk provisions under I.R.C. § 465?

CONCLUSIONS

Having adequate basis in their partnership interests, the limited partners are allowed their distributive shares of ordinary loss to the extent of their distributive shares of cancellation of indebtedness income under § 465. However, with no amount at risk, any limited partner's § 465(d) loss in excess of the limited partner's cancellation of indebtedness income is not allowed, even with adequate basis.

FACTS

X, a registered tax shelter, is a TEFRA limited partnership. X has one general partner, Y, and N limited partners ("LPs") consisting of individuals. In Yr1, X realized approximately \$D1 of cancellation of indebtedness ("COD") income through restructuring agreements with its creditors. The discharged debt included \$D2 of accrued interest owed to the general partner, a \$D3 loan from the city of G, and a \$D4 loan from the Z. None of the LPs was originally allocated shares of the liabilities. Thus, the LPs did not include the debt in the bases of their partnership interests. However, the partnership did allocate distributive shares of the COD income to the LPs. The LPs who did not qualify for exclusion under §108¹ included their distributive shares of the COD income in gross income. In addition to the COD income, the partnership reported a \$D5 ordinary loss in 1997, of which the LPs were allocated distributive shares. The partnership was an accrual basis taxpayer and had previously included the accrued interest, among the debt

¹Section 108(a)(1)(B) provides that gross income from discharge of indebtedness does not include amounts when the discharge occurs when the taxpayer is insolvent.

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discharged, as a deduction on the partnership return, thus creating the losses. As of December 31, Yr1, the losses were far in excess of all of the LPs' capital account balances. Moreover, as the LPs were not personally liable for the discharged debt, they would not be considered at risk for the discharged debt.²

LAW AND ANALYSIS

I. Effect of discharge on LPs' bases in their partnership interests

Section 61(a)(12) provides that except as otherwise provided in subtitle A, gross income means all income from whatever source derived, including (but not limited to) income from the discharge of indebtedness. See United States v. Kirby Lumber Co., 284 U.S. 1 (1931).

Section 702(a)(8) provides that income realized by a partnership on the discharge of indebtedness is passed through to the partners as ordinary income. See Gershkowitz v. Commissioner, 88 T.C. 984, 1005 (1987).

Section 108(d)(6) provides, in relevant part, that in the case of a partnership, § 108(a) (the exclusion of COD income from gross income) shall be applied at the partner level.

Section 705(a)(1) provides, in relevant part, that a partner's basis in his partnership interest is increased by his distributive share of such income and decreased by distributions made to him by 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 the individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

Section 733 provides that in the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to the partner of his interest in the partnership shall be reduced (but not below zero) by (1) the amount of any money distributed to the partner, and (2) the amount of the basis to the partner of distributed property other than money, as determined under § 732.

According to the facts submitted, X realized and recognized under § 61(a)(12) approximately \$D1 of COD income in 1997. Because any exclusion of COD income

²Section 465(b)(2) provides that a taxpayer is considered at risk with respect to borrowed amounts for use in such an activity to the extent he is personally liable for repayment of the borrowed amounts or has pledged property, other than property used in the activity, as security for the borrowed amounts.

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from gross income under § 108 is applied at the partner level pursuant to § 108(d)(6), X's LPs individually determined their qualification for the §108 exclusion for the distributive shares of the COD income they were allocated. Accordingly, any LP who was allocated a distributive share of COD income was required to increase his basis in his partnership interest by the amount of that income under § 705. For purposes of this reply, we were told that both the COD income and the ordinary losses were from the same activity and were properly allocated under the rules of § 704 and regulations thereunder. See Rev. Rul. 92-97, 1992-2 CB 124, for guidance on the allocation of partnership COD income.

Moreover, the discharge of X's debt resulted in an overall decrease in partnership liabilities. Under § 752(b), any decrease in a partner's share of the discharged partnership liabilities should be considered a distribution of money to the partner by X, which requires a decrease in the partner's basis under §§ 733 and 705. However, none of the LPs included an allocable share of the discharged debt in their bases. Therefore, no LP received a deemed distribution under § 752(b) requiring a decrease in the basis of his partnership interest by the amount of that distribution. Because X's COD income was allocated to its LPs, none of whom shared in the discharged liabilities, the LPs' basis increase was not matched by a basis decrease. In consequence, this resulted in a net increase in the LPs' bases.

II. Losses allowed under Section 465

Section 465(a)(1) provides that in the case of an individual and certain C corporations engaged in an activity to which § 465 applies, any loss from the activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of § 465(b)) for the activity at the close of the taxable year.

Section 465(b)(1) provides that a taxpayer shall be considered at risk for an activity with respect to amounts including (A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and (B) amounts borrowed with respect to the activity. Section 465(b)(2) provides that a taxpayer shall be considered at risk with respect to amounts borrowed for use in an activity to the extent that he (A) is personally liable for the repayment of the amounts, or (B) has pledged property, other than used in the activity, as security for the borrowed amount (to the extent of the net fair market value of the taxpayer's interest in the property). No property shall be taken into account as security if the property is directly or indirectly financed by indebtedness that is secured by property described in § 465(b)(1)).

Prop. Treas. Reg. § 1.465-1(a) provides that § 465 generally limits the amount of any loss described in § 465(d) that is otherwise deductible in connection with an activity described in § 465(c)(1). Under § 465 the amount of the loss is allowed as a deduction only to the extent that the taxpayer is at risk with respect to the activity

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at the close of the taxable year. The determination of the amount the taxpayer is at risk in cases where the activity is engaged in by an entity separate from the taxpayer is made as of the close of the taxable year of the entity engaging in the activity (for example, a partnership).

Prop. Treas. Reg. § 1.465-11(a)(1) provides that a taxpayer has a loss described in § 465(d) in a taxable year in an amount equal to the excess of allowable deductions allocable to an activity over the income received or accrued from the activity by the taxpayer for the taxable year. The loss is referred to as a § 465(d) loss in the regulations under § 465.

Prop. Treas. Reg. § 1.465-2(a) provides that in any taxable year, there are two ways in which deductions allocable to an activity to which § 465 applies will be allowable under § 465. First, deductions allocable to an activity and otherwise allowable will be allowable in a taxable year to the extent of income received or accrued from the activity in that taxable year. See the example at Prop. Treas. Reg. § 1.465-11(c)(2). Thus, to the extent there is income from the activity in a taxable year, deductions allocable to that activity will be allowable without regard to the amount at risk. Second, losses from the activity (that is, the excess of deductions allocable to the activity over the income received or accrued from the activity) will be allowable to the extent the taxpayer is at risk with respect to that activity at the close of the taxable year. See Lansburgh v. Commissioner, 92 T.C. 448, 453 (1989). In Lansburgh, the court found (and the Service acknowledged) that the taxpayer is entitled to deductions to the extent of gross income received from the activity. The Tax Court further found that deductions are allowable to the extent taxpayer is at risk.

Prop. Treas. Reg. § 1.465-11(c)(1) provides that a § 465(d) loss is determined without regard to the amount at risk. Thus, even if the taxpayer has no amount at risk in the activity, deductions are allowable under § 465 for a taxable year to the extent there is income from the activity in that taxable year. Illustrating this provision, the example in Prop. Treas. Reg. § 1.465-11(c)(2) provides that before taking into account any gain or loss during 1978, the amount that C, a calendar year taxpayer, is at risk in an activity described in § 465(c)(1) is equal to minus \$20,000. During 1978, C has deductions of \$10,000 allocable to the activity and income of \$15,000 from the activity. Because the income from the activity exceeds the amount of allocable deductions from the activity, there is no § 465(d) loss in 1978 to be disallowed under § 465(a). Thus, although C has a negative amount at risk, C is permitted to take deductions in the amount of \$10,000 for 1978.

Prop. Treas. Reg. § 1.465-22 provides that a taxpayer's amount at risk in an activity shall be: (a) increased by the amount of personal funds the taxpayer contributes to the activity; (b) decreased by the amount of money withdrawn from the activity (including distributions from a partnership) by or on behalf of the taxpayer; (c)(1) increased by an amount equal to the excess of the taxpayer's share of all items of

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income received or accrued from the activity during the taxable year over the taxpayer's share of allowable deductions which are allocable to the activity for the taxable year; and (c)(2) decreased by the amount of loss from the activity allowed as a deduction to the taxpayer under § 465(a).

Section 704(d) provides that a partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the partnership year in which the loss occurred. Any excess of the loss over the basis shall be allowed as a deduction at the end of the partnership year in which the excess is repaid to the partnership.

In 1997, X also recognized \$D5 of ordinary loss, distributive shares of which were presumably properly allocated to its partners. Subject to the at risk limitations, these losses were allowable or not to the LPs according to the rules under § 465. Under Prop. Treas. Reg. § 1.465-2(a), otherwise allowable deductions are allowed under § 465 in two ways: (1) to the extent of income received or accrued for the taxable year, without regard to amount at risk, and (2) to the extent a taxpayer is at risk for the taxable year. Under the provision, a loss must first be otherwise allowable under the code before it is allowed under the at risk provisions. Thus, a LP's distributive share of loss, subject to the basis limitation provision under § 704(d), is otherwise allowable only to the extent of the LP's basis in his partnership interest. Accordingly, a LP having adequate basis is allowed under Prop. Treas. Reg. § 1.465-2(a) a deduction for any distributive share of loss, irrespective of amount at risk, to the extent of any distributive share of COD income allocated to the LP. As discussed above, the LPs' bases increase from COD income was not offset by a decrease in basis for any deemed distribution they received under § 752(b). Therefore, with a net increase in their basis from the COD income, the LPs should be allowed a deduction for their distributive shares of ordinary loss to the extent of their shares of COD income.

Moreover, any otherwise allowable deductions in excess of income received or accrued for the taxable year constitutes a taxpayer's § 465(d) loss under Prop. Treas. Reg.

§ 1.465-11(a)(1). Thus, any LP's share of loss in excess of COD income would constitute a § 465(d) loss equal to that excess amount. Pursuant to Prop. Treas. Reg. § 1.465-2(a), a partner's § 465(d) loss is allowable to the extent that the partner is at risk at the close of the taxable year. Thus a LP's § 465(d) loss, if any, is limited by the LP's basis in the partnership and by the LP's amount at risk. The facts indicate that the LPs were not at risk with regard to the debt at the time of the discharge. Unless a LP made contributions to the partnership in the year of the discharge, no factor caused the LPs to increase their amounts at risk. Therefore, because none of the LPs were at risk for the debt at the time of the discharge, the LPs' § 465(d) losses should not be allowed.

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Please call (202) 622-7830 if you have any further questions.

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