



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 BARBARA M. LEONARD  
DISTRICT COUNSEL CC:WR:CCA:SJ

FROM: DEBORAH A. BUTLER  
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)  
CC:DOM:FS

SUBJECT: Contribution to Capital

This Field Service Advice responds to your memorandum dated November 12, 1998. 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:

P	=
Q	=
R	=
S	=
T	=
U	=
V	=
W	=
Year 1	=
Year 3	=
Year 4	=
\$u	= \$
\$v	= \$
\$w	= \$
\$x	= \$

$\$y$  = \$  
 $\underline{a}$  = percent  
 $\underline{b}$  = percent

ISSUE:

Whether the payment of a partnership liability by guarantors should be characterized as cancellation of indebtedness income or as a contribution of capital.

CONCLUSION:

The payment of the partnership liability by guarantors should be characterized as a contribution to capital.

FACTS:

P is a limited partnership. Q, an S corporation, is the sole general partner owning an  $\underline{a}$  percent interest. The remaining  $\underline{b}$  percent interests are owned by limited partners. R, S, T, U and V, all individuals, are shareholders of Q. In addition, R, S, T, U and V all own interests as limited partners in P, either directly or indirectly.

On August 11, Year 1, P obtained a recourse loan from W in the amount of \$u. The promissory note was secured by a Loan and Security Agreement and a Supplemental Security Agreement. Q executed a corporate guaranty, guaranteeing payment of the promissory note. R, S, T, U and V each executed a guaranty, in their capacity as shareholders of Q, guaranteeing the obligation of P.

As of May 1, Year 3, P had defaulted on the note. On May 4, Year 3, W filed a complaint for breach of the payments under the promissory note and the guaranty agreements.

On October 11, Year 3, W, P, Q, R, S, T, U and V entered into a Settlement Agreement and Comprehensive Settlement Agreement. Under the Comprehensive Settlement Agreement, P, Q, R, S, T, U and V agreed to pay W \$v of principal and accrued interest before October 15, Year 3, and \$w of principal plus accrued interest before October 15, Year 4. W agreed to discount the principal balance of the note by \$x.

In Year 3, P treated the payments by R, S, T, U and V as loans to P, and reported \$x of income from cancellation of indebtedness.<sup>1</sup> In Year 4, P treated the payments to W on the books and records of the partnership as a discharge of P's indebtedness and reported \$y from cancellation of indebtedness income. This income was allocated among the partners according to their interest in P. P liquidated in Year 4.

## LAW AND ANALYSIS

In general, a partner's basis in a partnership is equal to the amount of money and adjusted basis of property contributed by the partner to the partnership. I.R.C. § 722. The basis is adjusted to reflect an increase or decrease in the partner's share of partnership liabilities. I.R.C. § 752. Any increase in a partner's share of partnership liabilities is considered a contribution of money by the partner to the partnership, which increases the basis of the partner's interest. I.R.C. §§ 752(a); 722.

A partner's share of a recourse partnership liability<sup>2</sup> is the portion of the liability for which the partner or related person bears the economic risk of loss. Treas. Reg. § 1.752-2(a). A partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner would be obligated to make a payment to any person because that liability became due and payable and the partner would not be entitled to reimbursement from another partner or person. Treas. Reg. § 1.752-2(b)(1).<sup>3</sup>

The loan from W to P was a recourse liability. As the sole general partner of P, Q was secondarily liable on the debt and bore the economic risk of loss. See CAL. CORP. CODE § 15643 (West 1991). Because Q's share of partnership liabilities is increased by the amount of recourse liability, Q is considered to have made a contribution of money to P in the amount of the loan, which increases Q's basis in its interest in P by \$u. I.R.C. § 752(a); 722.

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<sup>1</sup> The parties agree that P realized \$x of income from cancellation of indebtedness in Year 3.

<sup>2</sup> A partnership liability is a recourse liability to the extent that any partner bears the "economic risk of loss" with regard to the obligation. Treas. Reg. § 1.752-1(a)(1).

<sup>3</sup> R, S, T, U and V do not bear the economic risk of loss with respect to the liability on account of their respective guarantees. In a constructive liquidation, Q is assumed to satisfy the liability, and R, S, T, U and V are assumed to not have to satisfy their respective guarantees. See Treas. Reg. 1.752-2(f) Ex. (3).

While R, S, T, U and V all held interests as limited partners in Q, either directly or indirectly, the supporting documents establish that the guarantees were executed in their capacity as shareholders of Q. Accordingly, the personal guarantees are considered as being executed by each individual in his capacity as shareholder of Q and not as limited partners of P.

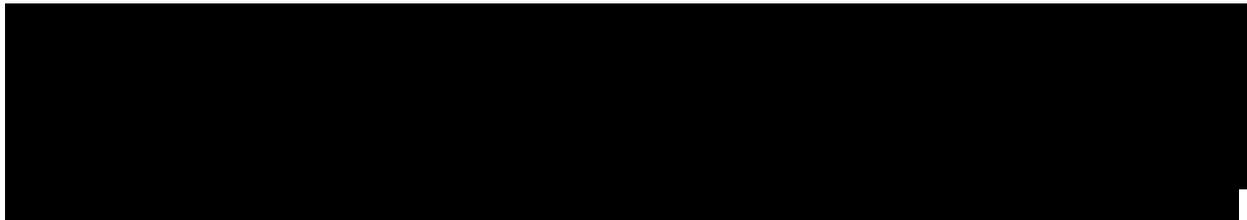
As of May 11, Year 3, P defaulted on the loan. On October 11, Year 3, P, Q, R, S, T, U, V, and W entered into a Settlement Agreement and Comprehensive Settlement Agreement. Under the Agreements, the liability to W was to be paid by R, S, T, U and V. Because the payments were made by R, S, T, U and V pursuant to their guarantees in their capacity as shareholders of Q, the payments are treated as if they were made to Q. Hence, the payments increased their respective basis in the stock of Q. I.R.C. §§ 1371(a), 358(a).

The subsequent deemed payment of P's debt by Q is considered a contribution to capital by Q. The deemed contribution to capital increases Q's basis in P. I.R.C. § 722.

Upon payment of P's debt by the shareholders of Q, P's liability to W is extinguished. Any decrease in a partner's share of partnership liabilities is considered a distribution of money by the partnership to the partner, which decreases the basis of the partner's interest. I.R.C. §§ 752(b); 733. Accordingly, Q's basis in its interest in P is decreased by the amount of the extinguished liability. I.R.C. §§ 752(b); 733.

Upon liquidation of P in Year 4, Q realized a loss to the extent its basis in P exceeded the amount realized. See I.R.C. § 731. Any loss recognized by Q passes through to its shareholders, R, S, T, U and V (I.R.C. § 1366(a)(1)(A)) and reduces R, S, T, U and V's respective basis in the stock of Q (which was previously increased by virtue of their payment of P's liability to W pursuant to their guarantees) by their prorata share of the loss (I.R.C. § 1367(a)(2)(B)).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



Please call if you have any further questions.

By: \_\_\_\_\_  
PATRICK PUTZI  
Special Counsel (Natural Resources)  
Passthroughs & Special  
Industries Branch  
Field Service Division