

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

July 16, 1999

Index (UIL) Number: 752.00-00
CASE MIS Number: TAM-107627-99
Number: **199943006**
Release Date: 10/29/1999

CC:DOM:P&SI:B1

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

PRS1 =

PRS2 =

PRS3 =

PRS4 =

PRS5 =

A =

B =

C =

D =

Trust1 =

Trust2 =

UPREIT=

X =

REIT =

Statel =

State2 =

Datel =

Date2 =

Date3 =

Date4 =

Yearl =

\$a =

\$b =

\$c =

\$d =

\$e =

\$f =

\$g =

\$h =

\$k =

ISSUE:

Is the contribution of properties to UPREIT by PRS1 in exchange for UPREIT interests, the immediate distribution by PRS1 of the UPREIT interests to the partners in PRS1, and the refinancing of debt securing the contributed properties, a "single transaction" for purposes of § 1.752-1(f).

CONCLUSION:

Yes. Therefore, the contributions and distributions to and from UPREIT as a result of the transaction will be netted for purposes of determining whether there is a net contribution by the partners to UPREIT or a net distribution by UPREIT to the partners.

FACTS:

PRS1 was formed by A, B, C, Trust1, and Trust2 (the Partners) on Date1. A and B each hold a one-third interest in PRS1 as general partners. The remaining one-third interest is held by C, Trust1, and Trust2 in equal shares as limited partners.

PRS1 is engaged in the business of owning and renting commercial real estate. At the close of Year1, the fair market value of PRS1's assets, including cash, buildings, land, and intangibles, was \$a. Its outstanding liabilities were valued at \$b. Of this amount, \$c were classified as nonrecourse loans attributable to the commercial real estate.

REIT is a State1 Real Estate Investment Trust. On Date3, the trustees of REIT approved the initial public offering ("IPO") of its shares, the formation and capitalization of UPREIT (a State2 limited partnership), and the obtaining of a \$d credit facility (Line of Credit) guaranteed by REIT for the UPREIT's use.

Pursuant to a contribution agreement (Agreement) dated Date2, PRS1 agreed to transfer the majority of its assets (the Audit Properties) and liabilities to UPREIT in exchange for UPREIT interests. PRS1 would then distribute these interests pro rata to the Partners. Under section 10 of the Agreement, the parties' obligations were conditioned upon, among other things, the consummation of the IPO by REIT, the borrowing by UPREIT (or an affiliate or subsidiary) of at least \$k, the availability of a working capital line of credit of at least \$d, and the sale or contribution by PRS1 or its affiliates and other third parties to UPREIT or one of its subsidiaries or affiliates of certain specified properties.

On Date4, PRS1 transferred the Audit Properties, subject to their attached mortgages and accrued liabilities, to UPREIT in exchange for UPREIT interests. PRS1 distributed the UPREIT interests to the Partners the same day. The UPREIT interests are redeemable for either cash or an equal number of common shares of the REIT. Following the contribution of PRS1's assets described above, the owners of UPREIT included REIT, A, B, C, D, Trust1, Trust2, and X as the sole general partner.

Concurrent with the contribution of the Audit Properties to UPREIT, the following events occurred:

- 1) UPREIT contributed certain properties, other than the Audit Properties, to PRS2 in exchange for a 99% limited partnership interest;
- 2) PRS2 obtained a nonrecourse loan for \$e, secured by its properties (including the properties contributed by UPREIT);
- 3) PRS3, a partnership in which UPREIT held a 99% interest, acquired 29 new properties subject to \$f in existing nonrecourse mortgage indebtedness;

- 4) PRS4, a partnership in which UPREIT held a 99% interest, acquired a shopping mall subject to an existing \$g nonrecourse loan;
- 5) PRS5, a partnership in which UPREIT held a 99% interest, acquired a mall subject to an outstanding nonrecourse mortgage of \$h;
- 6) UPREIT retired the existing mortgage indebtedness on the Audit Properties with proceeds raised by REIT in the IPO (and subsequently contributed to UPREIT) or from UPREIT's line of credit.

The PRS2, PRS3, and PRS4 mortgage loans were cross-collateralized and cross-defaulted with each other. The PRS5 loan was not cross-collateralized with the other loans. The Line of Credit was guaranteed by REIT. Accordingly, concurrent with the contributions of property by PRS1 to UPREIT, UPREIT was a partner in PRS2, PRS3, PRS4, and PRS5 (Subsidiary Partnerships). The Subsidiary Partnerships own properties subject to nonrecourse mortgage indebtedness. This indebtedness, under the rules of § 752, is allocated among the partners in UPREIT, thereby increasing their bases in their UPREIT interests.

LAW AND ANALYSIS:

Section 704(c)(1)(A) provides that under regulations prescribed by the Secretary, income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

Section 705(a)(1) provides that the adjusted basis of a partner's interest in a partnership is generally the basis of that interest determined under § 722 (relating to contributions to a partnership) or § 742 (relating to transfers of partnership interests) increased by the sum of the partner's share for that taxable year and prior taxable years of (A) taxable income of the partnership as determined under § 703(a), and (B) income of the partnership exempt from tax under Title 26. Similarly, the partner's basis is decreased by distributions from the partnership (as provided in § 733) and the sum of the partner's distributive share for that taxable year and prior taxable years of (A) losses of the partnership, and (B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.

Section 721(a) provides that no gain or loss is recognized by a partnership or to any of its partners in the case of a contribution of property to a partnership in exchange for an interest in the partnership. However, if the property is encumbered and the encumbrance becomes a liability of the partnership, then, under § 752(b) the contributing partner is deemed to receive a distribution of money from the partnership in an amount equal to the reduction in the share of the liability.

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership is the amount of the money and the

adjusted basis of the property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) by the contributing partner at the time of contribution.

Section 731(a)(1) provides that, in the case of a distribution by a partnership to a partner, gain is generally not 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 § 731(b), no gain or loss is recognized by a partnership on a distribution to a partner of property, including money.

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 that partner of partnership liabilities is considered a contribution of money by the partner to the partnership. Similarly, under § 752(b), any decrease in a partner's share of 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 is considered a distribution of money to the partner by the partnership. Section 752(c) provides that, for purposes of § 752, a liability to which property is subject is, to the extent of the fair market value of the property, considered a liability of the owner of the property. Sections 1.752-2, 1.752-3, and 1.752-4 of the Income Tax Regulations contain the rules for determining a partner's share of recourse and nonrecourse liabilities of a partnership.

Section 1.752-3(a) provides that a partner's share of 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 § 704(b) and the regulations thereunder; (2) the amount of any taxable gain that would be allocated to the partner under § 704(c) (or in the same manner as § 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 excess nonrecourse liabilities (those not allocated under paragraphs (a)(1) and (a)(2) of this section) of the partner's share of partnership profits.

The allocation of partnership liabilities among the partners serves to equalize the partnership's basis in its assets ("inside basis") with the partners' bases in their partnership interests ("outside basis"). Providing additional basis to a partner for the partner's partnership interest permits the partner to receive distributions of the proceeds of partnership liabilities without recognizing gain under § 731, and to take deductions attributable to partnership liabilities without limitation under § 704(d) (which limits the losses that a partner may claim to the basis of the partner's interest in the partnership). By equalizing inside and outside basis, § 752 simulates the tax consequences that the partners would realize if they owned undivided interests in the partnership's assets, thereby treating the partnership as an aggregate of its partners.

Section 1.752-1(f) provides a rule for a netting of increases and decreases of liabilities

resulting from the same transaction. Under that rule, if as the result of a single transaction a partner incurs both an increase and a decrease in the partner's share of the partnership liabilities (or the partner's individual liabilities), only the resulting net decrease is treated as a distribution from the partnership and only the resulting net increase is treated as a contribution of money to the partnership. Generally, the contribution to or distribution from a partnership of property subject to a liability will require that increases and decreases in liabilities associated with the transaction be netted to determine whether a partner will be deemed to have made a contribution or received a distribution as a result of the transaction.

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 § 752 and the regulations thereunder to the partners of the upper-tier partnership.

Rev. Rul. 79-205, 1979-2 C.B. 255, considers increases and decreases in partners' individual liabilities resulting from a transaction involving nonliquidating distributions of encumbered partnership properties. The facts of that ruling indicate that a partnership distributed two of its properties, one to each of its partners. Both properties were subject to liabilities at the time of the distribution.

The ruling states the general rule that partnership distributions are taxable under § 731(a)(1) only to the extent that the amount of money distributed exceeds the distributee partner's basis in his partnership interest. This rule reflects Congressional intent to limit the circumstances under which gain or loss is recognized to facilitate the movement of property into and out of partnerships as business reasons dictate. See S. Rep. No. 1622, 83d Cong. 2d Sess. 389 (1954). Relying on this general rule, the ruling concludes that, because the partners' shares of the liabilities are both increasing and decreasing in the same transaction, offsetting the increases and decreases tends to limit recognition of gain and thereby gives effect to Congressional intent. Accordingly, the ruling holds that, in a distribution of encumbered property by a partnership, the resulting liability adjustments will be treated as occurring simultaneously rather than in a particular order. Rev. Rul. 87-120, 1987-2 C.B. 161, amplified Rev. Rul. 79-205 by extending its holding to terminating distributions by a partnership of encumbered property as part of a single transaction and within the same taxable year.

The issue in this technical advice memorandum is similar to those discussed in Rev. Rul. 79-205 and Rev. Rul. 87-120. PRS1's contribution of property to UPREIT and the payment of the liabilities related to the Audit Properties results in a decrease in liabilities and a deemed distribution of money to the Partners. On the same day, however, there is a deemed contribution of money to UPREIT by the Partners to the extent that the Partners' shares of UPREIT liabilities increased due to the Subsidiary Partnerships' liabilities. Under the Agreement, these transactions would be related in the sense that one could not occur without the others. Accordingly, we conclude that any deemed contribution and the deemed distribution should be treated as parts of a single transaction for purposes of § 1.752-1(f). Therefore, any increases and decreases in the Partners' bases in their UPREIT interests resulting from the liability shifts will be netted for

purposes of determining the ultimate result of the transactions under §§731 and 752.

CAVEAT(S)

Except as specifically discussed above, no opinion is expressed or implied concerning the federal tax consequences of the facts described above under any other provisions of the Code. In particular we express no opinion concerning the actual amount of the Partners' respective bases in their UPREIT interests following the transactions discussed above.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.