



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
April 14, 2000

Number: **200028019**
Release Date: 7/14/2000
CC:DOM:FS:P&SI

UILC: 108.03-01
708.01-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

DISTRICT COUNSEL CC:

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Income from Discharge of Partnership Indebtedness

This Field Service Advice responds to your memorandum dated February 11, 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

A	=
B	=
C	=
D	=
E	=
Partner 1	=
Partner 2	=
<u>\$a</u>	=
<u>\$b</u>	=
<u>\$c</u>	=
<u>\$d</u>	=

<u>\$e</u>	=
\$f	=
\$g	=
\$h	=
\$i	=
\$j	=
\$k	=
w	=
x	=
y	=
z	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Year 1	=
Year 2	=

Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Month 1	=
Month 2	=
Month 3	=
Month 4	=
Month 5	=
Tax Year 1	=
Tax Year 2	=
District X	=
State Y	=

ISSUE

Whether the taxpayers realized cancellation of indebtedness income in Tax Year 1.

CONCLUSION

The taxpayers did not realize cancellation of indebtedness income in the Tax Year 1.

FACTS

A, a limited partnership, was formed on Date 1 to acquire, construct and lease commercial property (“the Property”). Partner 1, one of the four original managing general partners, received y percent of the partnership interests; the limited partner held a z percent interest. On Date 2, A obtained a \$b construction loan from B. Repayment of the principal was due on demand or by Date 3. As security for the loan, A executed a deed of trust and each of its managing partners executed a

recourse promissory note and personally guaranteed the loan. Construction on the Property was completed in Year 1.

By Date 3, the nationwide real estate market had declined and B agreed to extend the due date of the loan to Date 5. In Year 3, A discovered that toxic chemicals apparently from C and D had leaked onto the Property. Real estate values continued to decline in State Y and between Month 3 and Month 4 of Year 4, Partner 1 and his wife, Partner 2, acquired the general and limited partnership interests of the other partners for a nominal amount. Partner 1 held w percent of the partnership interests as general partner and Partner 2 held a z percent interest as limited partner.

On Date 4, B was placed into receivership. The receiver collected all rents and other revenue from the Property. On Date 6, B assigned to E certain assets including the debt of A. On Date 7, after attempting to collect from Partner 1, E filed suit against B, C, D and Partner 1 (both in his capacity as a general partner of A and as a guarantor) in the United States District Court for District X. Partner 1 filed a cross-complaint against C and D.

The indebtedness was reduced to an interlocutory judgment on Date 9. As of Date 9, the total balance of the unpaid loan was \$a, including interest. On Date 10, E entered into a settlement agreement with Partner 1 and A, where E agreed to pay them \$k in exchange for their dismissal of an appeal of the district court's decision to have all rents from the Property paid to the receiver. Partner 1 and A also agreed to pursue their claims against C and D; E agreed to pay their attorneys' fees and Partner 1 and A agreed that E's attorney would take the lead in the case. E agreed that as of the date of the sale of the Property, it would not enforce a deficiency judgment against either Partner 1 or A unless they fail to pursue their claims against C and D or they pursue such claims in a negligent manner (or if Partner 1's statement of net worth was false in a material way). Partner 1 and A also agreed to use their best efforts to sell the Property and that E was entitled to the proceeds from the sale of the Property. As of Date 10, the principal balance of the loan was \$c.

On Date 11, the Property (the sole asset of A) was sold for \$g. A deficiency determination was held and the outstanding liability on the note was determined to be approximately \$e. On or about Date 12, a deficiency judgment was entered against Partner 1 and A for \$d.

In Month 5 of Year 6, E settled its case against D for \$i and in Month 1 of Year 7, E settled its case against C for \$j. On Date 13, both the complaints and cross-complaints were dismissed. Also in Month 1 of Year 7, E dismissed the deficiency judgment against Partner 1 and A.

A filed a final Federal income tax return for Tax Year 1, reporting cancellation of indebtedness of \$f.¹ An attachment to the tax return states that all of A's unpaid debt was forgiven as of Date 10, the date of the settlement agreement with E. The Year 5 Form K-1 issued by A to Partner 1 included the cancellation of indebtedness income. A majority of the cancellation of indebtedness income was excluded from Partner 1 and Partner 2's joint Federal income tax return for Tax Year 1 based on the claim that they were insolvent at the time of the discharge of indebtedness (cancellation of indebtedness income was included into gross income to the extent that Partner 1 and Partner 2 were solvent). A statutory notice of deficiency was issued for Tax Year 1 adjusting the capital gain of Partner 1 and Partner 2.

E issued a Form 1099-C for Tax Year 2 to Partner 1 (not to A) for the excess of the deficiency judgment over the \$h recovered from C and D. The attorney for E has stated that E fully intended on pursuing collection from Partner 1 and/or A until Month 1 of Year 7 when the settlement was reached with C and D.

LAW AND ANALYSIS

The broad definition of gross income includes income from discharge of indebtedness. I.R.C. § 61(a)(12). See *United States v. Kirby Lumber*, 284 U.S. 1 (1931). However, if the discharge of indebtedness occurs when the taxpayer is insolvent, the discharge of indebtedness income is excluded from gross income. I.R.C. § 108(a). Insolvent is defined as the excess of liabilities over the fair market value of assets. I.R.C. § 108(d)(3).

In the case of a partnership, the discharge of partnership indebtedness is determined and realized at the partnership level while the insolvency exception is applied at the partner level. I.R.C. § 108(d)(6). See *Marcaccio v. Commissioner*, T.C. Memo 1995-174. Income from the discharge of indebtedness is treated as an item of income which is allocated separately to each partner under section 702(a). H. REP. NO. 833, 96th Cong., 2d Sess. (1980) at 17; S. REP. NO. 1035, 96th cong., 2d Sess. (1980), at 21.

The amount realized from the sale or other disposition of property subject to a nonrecourse liability includes the amount of liabilities from which the transferor is discharged. Treas. Reg. § 1.1001-2(a)(1). In contrast, the amount realized from the sale or other disposition of property subject to a recourse liability does not include the amount of indebtedness discharged. Treas. Reg. § 1.1001-2(a)(2). A partnership liability is treated as nonrecourse to the extent that no partner or related

¹ Although A's Year 5 Federal income tax return stated that it was the final return, A filed a Year 2 State Y Partnership Tax Return in or around Month 2 of Year 8.

person bears the economic risk of loss for the liability.² Treas. Reg. § 1.752-1(a)(2). A partnership liability is treated as a recourse liability to the extent that any partner or related person bears the economic risk of loss for the liability. Treas. Reg. § 1.752-1(a)(1).

When the debt was created on Date 2, each of the partners personally guaranteed the repayment of the debt and each partner executed a recourse promissory note. Accordingly, the debt was a recourse liability when A borrowed the funds. Based on the available information, there is no indication that any of the partners was relieved of personal liability when Partner 1 and Partner 2 acquired the partnership interests of the other partners between Month 3 and Month 4 of Year 4. Additionally, E did not provide Partner 1 with a release of Partner 1's recourse promissory note or Partner 1's guarantee of the loan. Instead, the settlement agreement entered into by Partner 1, A and E provided that "[a]s of the date of the sale of the Property, [E] agrees not to levy execute or otherwise enforce a deficiency judgment against [A] or [Partner 1] ... except if (a) the court determines that [A] and/or [Partner 1] intentionally fail to pursue or pursue in a grossly negligent manner its or his claims in this action ... or (b) [Partner 1's] statement of current net worth and income and expense verification dated Date 8, is false in a material way." Further, the attorney for E has informed District Counsel that E fully intended on pursuing collection from Partner 1 and/or A until Month 1 of Year 7 when the settlement was reached with C and D. Therefore, the debt was still a recourse liability after the settlement agreement was executed.³ Finally, the Property was sold by A on Date 11. We believe that the debt was still a recourse liability after the sale of the Property because E could have attempted to collect the outstanding liability from Partner 1 based on the recourse promissory note he executed and on Partner 1's personal guarantee of the debt.

A partnership is terminated for Federal income tax purposes only if "no part of any business, financial operation, or venture of the partnership continues to be carried

² A partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) due to the fact that the liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or a person related to another partner. Treas. Reg. § 1.752-2(b)(1).

³ In determining the year in which income should be reported, consideration cannot be given to what may or may not happen in a subsequent year. Barker v. Commissioner, T.C. Memo. 1983-643 (citing James v. United States, 366 U.S. 213 (1961); Grandview Mines v. Commissioner, 282 F.2d 700 (9th Cir. 1960); Clem v. Commissioner, T.C. Memo. 1962-13).

on by any of its partners in a partnership” or “within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in a partnership capital and profits.” I.R.C. § 708(b)(1). Between Month 3 and Month 4 of Year 4, Partner 1 and Partner 2 acquired x percent and z percent of the partnership interests in A, respectively. Accordingly, A terminated (for Federal income tax purposes) between Month 3 and Month 4 of Year 4 pursuant to section 708(b)(1)(B). There is also a question of whether A terminated under 708(b)(1)(A) at the time it disposed of the Property because it held no other assets and did not have any other activity. Although we believe that the sale of the Property did not cause a termination of A, we believe the issue of whether the partnership terminated is irrelevant to the issue of whether Partner 1 realized income from the cancellation of indebtedness because under the laws in State X, a partner is not relieved of liability on the date the partnership terminates.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



If you have any questions or need further assistance, please call (202) 622-7830.



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