Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:
Associate Area Counsel
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Internal Revenue Service

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subject: Application of section 731 and 752

This memorandum responds to your request for assistance dated December 1, 2008, concerning several examinations pending in the Large and Mid-Size Business Division (hereinafter "LMSB") regarding the application of §§ 731 and 752 of the Code. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice may not be used or cited as precedent.

ISSUE

Whether, under § 731(a)(1), a limited partner must recognize gain in the case of a distribution by a partnership to the limited partners under the circumstances described below.

CONCLUSION

Under § 731(a)(1), a limited partner must recognize gain in the case of a distribution by a partnership to the limited partner under the circumstances described

below to the extent that the distribution to them by Partnership exceeds their respective adjusted bases in their partnership interests immediately before the distribution.

FACTS

There are several examinations pending that involve the following fact pattern:

Partnership is a domestic limited partnership. Partnership has three partners. GP, its general partner, has a 1% interest, and LP1 and LP2, its limited partners, have a 94% and a 5% interest in Partnership respectively. LP1 is a wholly-owned domestic subsidiary of a foreign corporation, XYZ, Inc. GP is a wholly-owned domestic subsidiary of LP1. LP2 is a domestic partnership which has two partners, each of which owns 50 percent of the profits and capital interests of LP2, and each of which is a wholly-owned domestic subsidiary of a different wholly-owned domestic subsidiary of XYZ, Inc. Each of the three partners of Partnership contributed capital to Partnership in proportion to their interest in Partnership.

XYZ, Inc. lent to Partnership, on a recourse basis, an amount equal to or greater than the amount contributed to Partnership by its partners. The same day, Partnership distributed a percentage of the proceeds of the loan to GP, LP1, and LP2, in proportion to each partners' interest in the partnership.

The law of the state in which Partnership was formed provides that, in general, a limited partner is not liable for obligations of a limited partnership to third parties. However, if a limited partner knowingly receives a distribution, which at the time of the distribution causes the liabilities of a limited partnership to exceed the fair market value of the assets of the limited partnership, the limited partner will be liable to the limited partnership for the amount of the distribution. The limited partner's obligation to the partnership expires upon the expiration of three years from the date of the distribution.

LAW AND ANALYSIS

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized to the contributing partner at such time.

Section 731(a)(1) provides that, in the case of a distribution by a partnership to a partner, gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.

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 such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

Section 1.752-1(a)(1) of the Income Tax Regulations provides that a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under § 1.752-2.

Section 1.752-2(a) provides that a partner's share of a recourse liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss.

Section 1.752-2(b)(1) provides that, except as otherwise provided in § 1.752-2, 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) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.

Section 1.752-2(b)(6) provides that, for purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.

Section 1.752-2(j)(1) provides that an obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of § 1.752-2 if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Circumstances with respect to which a payment obligation may be disregarded include, but are not limited to, the situations described in § 1.752-2(j)(2) and § 1.752-2(j)(3).

Section 1.752-2(j)(3) provides that an obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.

Section 707(a) of the Code provides that if a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction will generally be considered as occurring between the partnership and one who is not a partner. Under § 1.707-1(a) of the regulations, a loan of money by the partnership to the partner is considered to be such a transaction. However, a transfer of money by the partnership to the partner as a distribution is not considered as a

transaction which the partner enters into in a capacity other than as a partner.

Section 1.731-1(c)(2) of the regulations provides that the receipt of money by a partner from the partnership under an obligation to repay the money is a loan rather than a distribution. For purposes of § 707(a) of the Code and the regulations thereunder, however, a loan by a partnership to a partner is considered to have been made only where the partner is under an unconditional and legally enforceable obligation to repay a sum certain at a determinable date. Rev. Rul. 73-301, 1973-2 C.B. 215.

Given that the XYZ, Inc. loan to Partnership is a recourse loan, immediately prior to the distribution, only GP bore the economic risk of loss for the loan. Thus, immediately prior to the distribution, the extension of the loan to Partnership increased GP's share of partnership liabilities in an amount equal to the entire amount of the loan. For purposes of determining GP's basis in its partnership interest in Partnership, the increase in GP's share of partnership liabilities was treated as a contribution of money by GP to Partnership equal to the entire amount of the loan. As a result, GP's basis in its partnership interest in Partnership was increased by an amount equal to the amount of the loan. Correspondingly, LP1 and LP2 received no increase in the bases of their partnership interests in Partnership. Upon the distribution of a percentage of the loan proceeds by Partnership to its partners, LP1 and LP2 each recognized gain to the extent that the amount of the distribution received by each of them exceeded the adjusted basis of each partner's interest in the partnership immediately before the distribution.

We understand that LP1 and LP2 may argue that, even if the distributions otherwise exceed their respective adjusted bases, they do not recognize gain on the distributions made to them because under state law they may, at some time, be obligated to return the distributions. We do not agree. Although under some circumstances a distribution by a partnership to a partner will be treated as a loan rather than a distribution under § 1.731-1(c)(2), those circumstances are not present in the instant case.

Additionally, we understand that LP1 and LP2 argue that they can use the anti-abuse rules of § 1.752-2(j)(1) and § 1.752-2(j)(3), as well as § 1.752-2(b)(6), to recharacterize the transaction to increase LP1 and LP2's bases in their partnership interests prior to the distribution by the amount of the distribution. We do not agree. As noted above, we do not agree that, prior to the distribution, LP1 and LP2 bear any economic risk of loss with respect to the XYZ loan. Further, GP, LP1, and LP2 may not utilize § 1.752-2(j) or § 1.752-2(b)(6) to undo the form of the transaction chosen by the parties. Although, the Service and the courts may pierce the form of a transaction and tax it according to its substance, the Supreme Court has long recognized the principle that a taxpayer may not disavow the form chosen for its transaction. See, for example, Higgins v. Smith, 308 U.S. 473, 477 (1940) and Gregory v. Helvering, 293 U.S. 465, 469 (1935).

Based on the foregoing, we conclude that LP1 and LP2 recognize gain to the extent that the distribution to them by Partnership exceeds their respective adjusted bases in their partnership interests. Additionally, we note that you have requested that we focus our assistance on the application of §§731 and 752 to the distribution made by Partnership to LP1 and LP2 under the facts described. Hence, no opinion is expressed concerning the federal tax consequences of other aspects of the facts described or the tax consequences of the facts described under any other provision of the Code.

Please call Frank J. Fisher of this office at (202) 622-3050 if you have any further questions.