Recent Developments Affecting Real Estate and Partnerships

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REAL ESTATE AND PARTNERSHIPS

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RECENT DEVELOPMENTS AFFECTING REAL ESTATE AND PARTNERSHIPS

I. PROPOSED 1992 LEGISLATION

H.R. 11. The following are the key real estate-and partnership-oriented provisions of H.R. 11, which has been approved by Congress and forwarded to the President, without action yet (although actual or pocket veto is threatened) by the President.

A. Modification of Passive Loss Rules. Under present law, all rental real estate activities are treated as "passive activities"; accordingly, it is immaterial whether or not the taxpayer satisfies the material participation tests, which includes spending at least 500 hours in real property operations. A special rule permits the deduction of up to $25,000 of losses from rental real estate activities (even though they are considered passive), if the taxpayer "actively participates" in them. This $25,000 amount is allowed for taxpayers with adjusted gross incomes of $100,000 or less, and is phased out for taxpayers with adjusted gross incomes of $100,000 to $150,000.

Under H.R. 11, new Section 469(c)(7) would be added to the Code. It would provide that the passive activity limitations would not per se exclude taxpayers in real property trades or businesses under certain circumstances, thereby enabling such taxpayers to be subject to the same material participation tests as other taxpayers. If the taxpayers can then meet those material participation rules, they can offset rental real estate income and losses against other income or losses in the same manner as any other business person. The following rules would apply to such taxpayers:

1. The term "passive activity" under Sec. 469(c)(2), I.R.C. would not include any rental real estate activity of such taxpayer for the taxable year.

2. This would be applicable to a taxpayer for a taxable year if more than one-half of the personal services performed in trades or businesses by the taxpayer are performed in real property trade or businesses in which the taxpayer materially participates.

a. "Real property trade or business" means any real property development, redevelopment, construction reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business.
b. Personal services performed as an employee will only be treated as performed in a real property trade or business if the employee is a 5 percent owner (as defined in Sec. 416(i)(1)(B), I.R.C.) in the employer.

c. In the case of a closely held C corporation, these requirements are treated as met if more than 50 percent of the gross receipts of such corporation for such taxable year are derived from real property trades or businesses in which the corporation materially participates.

3. Each interest of the taxpayer in rental real estate will be treated as a separate activity, unless the taxpayer elects to treat all interests in rental real estate as one activity.

4. The question of whether the taxpayer materially participates with respect to any interest in a limited partnership as a limited partner is determined under the material participation regulations.

B. Real Estate Investments by Pension Funds and Others.

1. Relaxation of "Debt-Financed Property" Rules. H.R. 11 relaxes the rules for treating income from debt-financed property as "unrelated business taxable income" ("UBTI") by allowing (i) a leaseback of real property to the seller thereof (or a related party) of no more than 25% of the leasable space and the lease is on commercially reasonable terms, (ii) seller financing on commercially reasonable terms and (iii) a participation feature at the time of sale of no more than 30% of the value of the property, and easing the requirements of fixed sales pricing with respect to purchases from financial institutions which acquired the property by foreclosure and acquisitions from a financial institution at the time it goes into conservatorship or receivership.

2. Repeal of Automatic "UBTI" Rule for Publicly-Traded Partnerships. For purposes of the UBTI rules, H.R. 11 treats investments of a tax-exempt organization in a publicly-traded partnership the same as an investment in any other partnership.

3. Exclusion of Loan Commitment Fees and Option Premiums from UBTI. Loan commitment fees and premiums from unexercised options on real estate are excluded from UBTI.

4. Investments in REITS by Pension Funds. Under current law, a pension trust is treated as one shareholder for purposes of the "five or fewer rule" of ownership in a REIT. H.R. 11 provides that each beneficiary of a pension trust holds stock in the REIT in proportion to his or her actuarial interest
in the pension plan. The Bill also modifies the treatment of dividends from REITs for purposes of computing UBTI.

C. **Low-Income Housing Credit.** H.R. 11 permanently extends the low-income housing credit and allows an owner of a building placed in service before 1990 to calculate the maximum allowable rent based on either apartment size or family size.

D. **Increase in Recovery Period for Real Property.** H.R. 11 increases the depreciation recovery period for nonresidential real property from 31.5 years to 40 years, effective as to property placed in service on or after July 28, 1992, subject to binding commitment and commencement of construction exceptions.

E. **Discharge of Indebtedness and Reduction of Tax Attributes.** The interplay between Secs. 108 and 1017, which was eliminated from the Code in TRA 1986, would be reinstated. Thus, an individual taxpayer would have an election to exclude from gross income certain income from the discharge of qualified real property indebtedness. The amount so excluded could not exceed the basis of certain depreciable real property of the taxpayer and would be treated as a reduction in the basis of that property. Partnerships and S corporations would be expressly enabled to work with this provision. The provision would be effective with respect to discharges after December 31, 1991 in taxable years ending after that date.

F. **Passive Activity Losses and Credits as a Tax Attribute in Discharges of Indebtedness.** Effective with respect to taxable years beginning after December 1, 1992, passive activity loss and credit carryovers from the taxable year of the discharge of indebtedness are added to the list of tax attributes under Secs. 108(d)(8) and 1398(g), I.R.C., that are reduced in the case of a discharge of indebtedness of the taxpayer that is excludable from income under Sec. 108(a)(1), I.R.C.

G. **Partnership Provisions.** A number of changes are made as to partnerships, including (1) simplified flow through of tax items for large partnerships (that is, partnerships with at least 250 partners or electing partnerships with at least 100 partners), (2) simplified audit procedures for large partnerships and (3) the requirement that a large partnership must furnish information returns to partners by the first March 15 following the close of the partnership’s tax year. The first two of these provisions are effective for partnership taxable years ending on or after December 31, 1993, and the third is effective for partnership taxable years ending on or after December 31, 1992.
II. PROPOSED AND FINAL REGULATIONS

A. Sec. 108, I.R.C. (Discharge of Indebtedness Income)

Prop. Reg. §1.108-2 is intended to provide rules governing the treatment of an acquisition of indebtedness by a person related to the debtor within the meaning of Sec. 267(b) or Sec. 707(b)(1). Prop. Reg. §1.108-2(a) provides that the acquisition of outstanding indebtedness by a person related to the debtor from a person who is not related to the debtor results in the realization of income by the debtor from discharge of indebtedness. This rule will apply whether the acquisition of the debt is direct or indirect, with an indirect acquisition being a transaction in which the related holder acquired the debt in anticipation of becoming related to the debtor. Prop. Reg. §1.108-2(b)(2)(i). The amount of such income realization is measured by reference to the fair market value of the indebtedness on the date of acquisition.

The income realization rule of Prop. Reg. §1.108-2 is made specifically inapplicable to a direct or indirect acquisition of indebtedness with a stated maturity date on or before the date that is one year from the date of acquisition if the indebtedness is, in fact, retired on or before such stated date. Prop. Reg. §1.108-2(d)(1). The rule is also inapplicable to any direct or indirect acquisition in the ordinary course of business by a securities dealer if the dealer (a) accounts for the debt as a security held primarily for sale to customers in the ordinary course of business, (b) disposes of the debt within a period consistent with the holding of the debt for sale to customers in the ordinary course, and (c) does not transfer the debt to a person related to the debtor, other than another securities dealer satisfying the requirements of this exception.

If discharge of indebtedness income is realized by a debtor under the provisions of Prop. Reg. §1.108-2(a), then the debt is to be treated as new indebtedness issued by the debtor to the related holder on the date of acquisition. The deemed issuance price of the new indebtedness is equal to the fair market value of such indebtedness. The excess of the stated redemption price at maturity of the debt over the deemed issuance price of the new debt is original issue discount, which is subject to deduction by the debtor and inclusion by the holder.

The Proposed Regulations also establish a system of "correlative adjustments" designed to reconcile the realization of discharge of indebtedness income with the fact that the debt remains outstanding in the hands of the related party. If the debtor realizes discharge of indebtedness income, the debtor is treated as having issued new debt to the related party holder with an issue price equal to the fair market value of the deemed new debt. The excess of the stated redemption price at maturity
of the deemed new debt over its issue price constitutes original issue discount.

The preamble to the Proposed Regulations states that the Treasury intends to issue regulations designed to prevent elimination of discharge of indebtedness income in certain nonrecognition transactions, including transactions described in Secs. 332, 351, 368, 721 and 731. Such regulations will be effective for any transaction on or after March 21, 1991. However, in Notice 91-15, 1991-1 C.B. 519, the Service clarified this portion of the preamble with respect to the transfer of partnership debt to a partnership in exchange for a partnership interest.

B. Sec. 468B, I.R.C. (Designated Settlement Funds).

Prop. Reg. §1.468B would subject a "qualified settlement fund" to a tax on its gross income at the maximum rate provided under Sec. 1(e), I.R.C. (currently 31%). Sec. 468B already provides for a similar elective tax treatment of a "designated settlement fund". Under the Proposed Regulation, however, any designated settlement fund would be treated as a qualified settlement fund, and the tax treatment set forth would, under the Proposed Regulation, be mandatory, not elective.

A "qualified settlement fund" is defined by the Proposed Regulation as any fund, account or other arrangement which qualifies as a trust under applicable state law or the assets of which are otherwise segregated from other assets of the transferor pursuant to an order of, or which is approved or supervised by, a Federal, state or local governmental authority in order to resolve or satisfy claims arising out of tort, breach of contract or violation of law, or under the Comprehensive Environmental Response, Compensation and Liability Act.

Under the Proposed Regulation, the only deductions available with respect to a qualified settlement fund are those for administrative costs, and losses from the sale of assets or worthlessness of property. The Proposed Regulation excludes any deduction for operating expenses of any business assets held by a fund.

C. Sec. 469, I.R.C. (Definition of "Activity").

1. Promulgation -- On May 12, 1992, the Service promulgated Prop. Reg. §1.469-4, dealing with definition of an "activity". In doing so, the Service allowed Temp. Reg. §1.469-4T to sunset. As noted by the Service, the Temporary Regulations were "criticized as overly long and complex, burdensome for small taxpayers, and mechanically inflexible", and the Proposed Regulations are "shorter and more flexible" and are intended to "be easier to apply and ease the burden on small taxpayers".
2. **The Rules** -- The following are the key considerations in utilizing the Temporary Regulations and the Proposed Regulations:

   a. Although Congress never legislated a definition of "activity", the legislative history of Section 469 indicates that an "activity" is meant to be the aggregation of all undertakings which "consist of an integrated and interrelated economic unit for the measurement of gain or loss". See S. Rep. No. 99-313, 99th Cong., 2d Sess., 739 (1986).

      (1) Generally, more than one activity was deemed to exist where two or more substantially different products or services were provided.

      (2) It should be noted that if the two or more products or services are customarily, or for business reasons, provided together (such as the clothing and appliance sections of a department store), then a single activity may exist.

      (3) On the other hand, different stages of producing and selling a particular product that are not carried on in an integrated fashion will generally constitute separate activities. S. Rep. No. 99-313, 99th Cong., 2d Sess., 740 (1986).

      (a) For example, the operation of a retail gas station is an activity distinct from the extraction of the raw materials via the drilling process.

      (b) Likewise, the Senate believed that real estate construction and development activities would be considered as separate from the activity of leasing the building. S. Rep. No. 99-313, 99th Cong., 2d Sess., 743 (1986).

   b. The following summarizes Temp. Reg. §1.469-4T:

      (1) It was generally reasonable to treat operations that involved similar goods or services as part of the same activity, though different operations could also be grouped together if they were conducted at the same location and were owned substantially by the same persons and in the same proportions.

      (2) However, it was not reasonable to treat rental operations as part of a trade or business activity or to treat non-rental operations as part of a rental activity unless the operations are ancillary to the activity and insubstantial in comparison to the activity. Temp. Reg. §1.469-4T(p)(2)(i), (ii). Thus, real estate development and construction operations may not
be treated as part of the rental activity even if the taxpayer rents the property on completion of those operations. Notice 88-94, 1988-2 C.B. 419.

c. Further focusing on Temp. Reg. §1.469-4T, as to taxable years ending after August 9, 1989 and on or before May 10, 1992, the definition of "activity" for purposes of applying Section 469 was further dissected into "undertakings", each of which is then either aggregated with other undertakings to form an "activity" or is singled out to become an "activity" by itself. Temp. Regs. §§1.469-4T(a)(2)(i) and (ii).

(1) Generally, an "undertaking" is a business and rental operation that constitutes a separate source of income production. Temp. Reg. §1.469-4T(c)(1).

(2) A separate source of income production is those operations which are conducted at the same location (that is, same physical structure or within close proximity) and owned by the same person and which are income-producing operations. Temp. Regs. §§1.469-4T(c)(2)(i)(A) and (B).

(a) Income-producing operations are operations conducted at a location and relate to (1) the production of property at that location; (2) the sale of property to customers at that location; (3) the performance of services for customers at that location; (4) transactions in which customers take physical possession of property that is made available for their use; or (5) any other transactions where customers are on the premises. Temp. Reg. §1.469-4T(c)(2)(iv).

(b) On the other hand, support operations are those operations which are not income-producing operations and which provide services or property at one location for the benefit of the owner’s operations at a different location. Temp. Reg. §1.469-4T(c)(2)(ii)(B).

(i) Support operations may never be considered to be activities. Temp. Reg. §1.469-4T(c)(2)(ii)(A)(1).

(ii) However, the income and expenses emanating from a support operation will be reasonably allocated to the activity or activities it supports. Temp. Reg. §1.469-4T(c)(2)(ii)(A)(2).

(3) Following the classification of business and rental operations into undertakings, the taxpayer must next separate his or her operations into three types of undertakings: (x) trade or business undertakings; (y) rental real estate undertakings; and (z) other rental undertakings.
(a) Generally, each trade or business undertaking is a separate activity unless there is mandatory aggregation. Temp. Reg. §1.469-4T(a)(4)(i).

(b) On the other hand, trade or business undertakings that are both similar and controlled by the same interests are part of the same activity. Temp. Reg. §1.469-4T(a)(4)(ii)(B).

(i) Undertakings are similar if (1) more than 50% of the gross income of such undertakings is attributable to operations in a single line of business or (2) the undertakings are vertically integrated. Temp. Regs. §§1.469-4T(f)(4)(i),(ii) and (iii). See Rev. Proc. 89-38, 1989-1 C.B. 920, for a sample list of 79 lines of business.

(ii) The determination of control of any type, whether exercisable or exercised, depends on the facts and circumstances, though it should be noted that there will be a rebuttable presumption of control between two undertakings if they are part of the same common ownership group. Temp. Regs. §§1.469-4T(j)(1) and 1.469-4T(j)(2)(i).

(A) A common ownership group is formed when the sum of the common ownership percentages of 5 or fewer persons (individuals or C corporations) exceeds 50%. Temp. Reg. §1.469-4T(j)(2)(ii).

(B) A person’s ownership percentage in an undertaking is derived from three sources: (1) direct ownership; (2) constructively ownership attributed through Secs. 267(b) and 707(b)(1); and (3) ownership through a pass-through entity. Temp. Reg. §1.469-4T(j)(3)(i) and 1.469-4T(j)(3)(iii).

(c) A rental real estate undertaking is an undertaking where at least 85% of the unadjusted basis of the property made available for use by customers is real property. Temp. Reg. §1.469-4T(k)(1)(ii).

(i) Rental real estate activities may be aggregated or disaggregated for the most advantageous consequences to the taxpayer subject to two caveats.

(A) First, if rental real estate undertakings are held through a passthrough entity, a taxpayer must keep the undertakings aggregated if the passthrough entity does so. Temp. Reg. §1.469-4T(k)(2)(ii). In order to provide their owners with maximum flexibility, partnerships and S corporations should not show their rental real estate undertakings aggregated on their informational returns.
(B) Second, a taxpayer must be consistent from year to year in the activity structure chosen. Temp. Reg. §1.469-4T(k)(3).

(ii) A taxpayer with rental real estate undertakings may also disaggregate a single undertaking into multiple activities, which may all the taxpayer to free up losses upon disposition.

d. The following summarizes Prop. Reg. §1.469-4:

(1) "Trade or business activities" are activities -- other than rental activities (as defined under Temp. Reg. §1.469-1T(e)(3)) or activities treated under Temp. Reg. §1.469-1T(e)(3)(vi)(B) as incidental to an activity of holding property for investment -- that:

(a) Involve the conduct of a trade or business (within the meaning of Section 162);

(b) Are conducted in anticipation of the commencement of a trade or business; or

(c) Involve research or experimental expenditures that are deductible under Sec. 174. Prop. Reg. §1.469-4(b)(1).

(2) One or more trade or business activities or rental activities are treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss under Sec. 469. Prop. Reg. §1.469-4(c)(1).

(a) Whether activities are treated as a single activity generally depends on all the relevant facts and circumstances. Prop. Reg. §1.469-4(c)(2).

(b) A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities. Prop. Reg. §1.469-4(c)(2).

(c) The following factors, not all of which are necessary to group more than one activity into a single factor, are given the greatest weight in applying the facts and circumstances:

(i) Similarities and differences in types of business;

(ii) The extent of common control;
ownership;

(iv) Geographical location; and

(v) Interdependencies between the activities. Prop. Reg. §1.469-4(c)(2).

(3) A rental activity may not be grouped with a trade or business activity unless one is insubstantial in relation to the other. Prop. Reg. §1.469-4(d).

(4) An activity involving the rental of real property and an activity involving the rental of personal property (other than personal property provided in connection with the real property) may not be treated as a single activity. Prop. Reg. §1.469-4(e).

(5) Generally, a taxpayer who is a limited partner or limited entrepreneur (under Sec. 464(e)(2)) may not group that activity with any other activity. However, there are exceptions where the grouping (1) will be with another activity that is in the same type of business if the taxpayer is a limited partner or limited entrepreneur in the other activity, or (2) will be with another activity in the same type of business in which the taxpayer is not a limited partner or limited entrepreneur, but the grouping is appropriate under the facts and circumstances. Prop. Reg. §1.469-4(f).

(6) Once the taxpayer has grouped activities, consistency is required. Accordingly, the taxpayer may not regroup such activities in subsequent taxable years unless the original grouping was clearly inappropriate or there has been a material change in the facts and circumstance. In such an event, the taxpayer must regroup the activities, complying with disclosure requirements. Prop. Reg. §1.469-4(g).

(7) The Service may regroup a taxpayer’s activities if the taxpayer’s grouping fails to reflect one or more economic units and one of the primary purposes of the taxpayer’s grouping is to circumvent the underlying purpose of Sec. 469. Prop. Reg. §1.469-4(h).

(8) Partnerships or S corporations must group their activities under Prop. Reg. §1.469-4. Then the partner or shareholder does likewise as to the passthrough entity’s activities. Prop. Reg. §1.469-4(j).

(9) A partial disposition, as to a substantial part of an activity, may be treated as a separate activity if the income, deductions and credits allocable thereto.
can be established with reasonable certainty by the taxpayer. Prop. Reg. \$1.469-4(k).


D. Sec. 707(a)(2), I.R.C. (Transactions between Partners and Partnerships).

1. Promulgation -- On April 25, 1991, the Proposed Regulations on "disguised sales" of property between partners and partnerships were issued. On September 30, 1992, the final Regulations were issued.

2. In General -- Under Reg. \$1.707-3(b)(1), a partner's transfer of property to a partnership and the partnership's transfer of money or other consideration to that partner are deemed a sale of the property by the partner to the partnership if

a. the transfer of money or other consideration would not have been made by the partnership but for the partner's transfer of property, and

b. either (1) the transfers are made simultaneously, or, if not, (2) the partnership's distribution is not dependent on the entrepreneurial risks of partnership operations. Reg. \$1.707-3(b)(1).

3. Presumption of Sale -- If, within a 2-year period, there are both a contribution by a partner to the partnership and a distribution by the partnership to that partner, these "interrelated" transfers are presumed to be a sale of the property to the partnership. Reg. \$1.707-3(c)(1).

a. The presumption is rebuttable only if "the facts and circumstances clearly establish that the transfers do not constitute a sale." Reg. \$1.707-3(c)(1).
b. If (i) an unfavorable presumption exists, but (ii) the partner nonetheless does not reflect the transaction as a sale, and (iii) the transfer is not presumed to fall under Regs. §§1.707-4(a)(1)(ii), (a)(3) or (b)(2) as a guaranteed payment, reasonable preferred return or operating cash flow distribution, then the partner must disclose the same on his tax return for the year of the transfer. Regs. §§1.707-3(c)(2) and -8.

c. If the contribution and distribution are more than 2 years apart, then these transfers are presumed not to be a sale of the contributed property, "unless the facts and circumstances clearly establish that the transfers constitute a sale." Reg. §1.707-3(d). See Reg. §1.707-3(f), Examples 5 through 7.

4. Factors Indicating Sale -- Over and above the presumptions, Reg. §1.707-3(b)(2) sets forth 10 factors that (although not exclusive) are considered evidence of the existence of a sale, as follows:

a. The timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer. (Note that Reg. §1.707-3(c)(1) disregards the order of the transfers.)

b. The transferor has a legally enforceable right to the subsequent transfer.

c. The partner’s right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured.

d. Any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the distribution.

e. Any person has loaned or has agreed to lend the partnership the money or other consideration in order to enable the partnership to make the transfer, taking into account whether the lender’s obligation is subject to contingencies related to the results of partnership operations.

f. The partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt.

 g. The partnership holds liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer.
h. The partnership distributions or allocations or control of partnership operations are designed to effect an exchange of the burdens and benefits of ownership of the contributed property.

i. The transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits.

j. The contributing partner has no obligation to return or repay the money or other consideration to the partnership, or, if such an obligation exists, it is likely to become due at such a future time that the present value of that obligation is small when compared with the amount of money or other consideration transferred by the partnership to the partner.

5. Guaranteed Payments -- A "guaranteed payment for capital" (that is, any payment to a partner by a partnership determined without regard to partnership income and for the use of that partner's capital) is not treated as part of a sale of property. Reg. §1.707-4(a)(1)(i).

a. The payment must be "reasonable". Reg. 1.707-4(a)(1)(ii). Reasonableness is considered as occurring, irrespective of any other measurement, only if there is a written provision of the partnership agreement providing for payment for the use of capital in a reasonable amount. Reg. §1.707-4(a)(3)(i). Whether the amount is reasonable is determined by multiplying the partner's unreturned capital (including any unpaid guaranteed payment or preferred return for any prior year) at the beginning of the year by a "safe harbor" interest rate of 150 percent of the highest applicable Federal rate in effect from the starting point through the end of the taxable year. Reg. §1.707-4(a)(3)(ii).

b. The payment must be characterized as a guaranteed payment. Reg. §1.707-4(a)(1)(ii). However, the characterization will not control in actually making a determination. Reg. §1.707-4(a)(1)(i).

6. Preferred Returns -- Preferred returns (which are preferential distributions to a partner of partnership cash flow with respect to capital contributed by the partner to the partnership that are to be matched, to the extent available, by an allocation of income or gain) are essentially treated the same as guaranteed payments. Reg. §1.707-4(a)(2).

7. Operating Cash Flow Distributions -- A distribution of operating cash flow is presumed not to be part of
a disguised sale unless the facts and circumstances clearly establish otherwise. Reg. §1.707-4(b).

8. Reimbursements of Preformation Expenditures -- Under Reg. §1.707-4(d), payments made to reimburse partners for capital expenditures that qualify as partnership organization and syndication costs under Sec. 709, I.R.C. are not considered proceeds of a disguised sale, so long as such reimbursement does not exceed 20 percent of the value of the contributed property at the time of the contribution (except that the 20 percent limitation does not apply if the fair market value of the contributed property does not exceed 120 percent of the partner's adjusted basis in the contributed property at the time of contribution). Reg. §1.707-4(d)(2)(ii).

9. Treatment of Liabilities -- Contributions of encumbered property to a partnership may be treated as disguised sales to the extent of the debt deemed shifted to noncontributing partners, depending on whether the liability is a "qualified" or "non-qualified" liability and on whether it is recourse or nonrecourse. Reg. §1.707-5.

   a. In contrast to the Proposed Regulations, these Regulations interface with those under Sec. 752 as to the recourse debt and, although not in full, nonrecourse debt. Regs. §§1.707-5(a)(2)(ii) and (iii).

   b. A liability is a "qualified liability" if and to the extent that it meets one of the following tests:

      (1) The liability was incurred by the partner more than 2 years prior to the earlier of (x) the date of contribution of the property or (y) the date the partner agreed in writing to contribute the property, and such liability has encumbered the property throughout the 2-year period. Reg. §1.707-5(a)(6)(i)(A).

      (2) The debt was incurred by the partner within the 2-year period prior to the earlier of (x) the date of contribution to the partnership or (y) the date of the agreement in writing to contribute the property, and such liability has encumbered the property throughout the period since it was incurred, but the facts and circumstances clearly establish that the liability was not incurred in anticipation of the contribution. Reg. §1.707-5(a)(6)(i)(B).

(4) The debt was incurred in the ordinary course of the trade or business in which the contributed property was used or held; provided, however, that substantially all of the assets of such activity must be contributed to the partnership; and provided, further, that, if the liability is a recourse liability, the amount of the liability does not exceed the fair market value of the transferred property (net of other applicable liabilities senior in priority) at the time of the transfer. Reg. §1.707-5(a)(6)(i)(D).

10. **Effective Dates** -- Under Reg. §1.707-9(a)(1), the Regulations apply to any transaction with respect to which all transfers that are part of a sale of an item of property occur after April 24, 1992. However, the Proposed Regulations may be applied to any such transaction so long as at least one of the transfers considered part of a sale occurs before November 30, 1992. Transactions occurring in whole or in part before April 25, 1991 and, generally, after March 31, 1984 are determined on the basis of Sec. 707(a)(2) itself and the legislative history of the 1984 Tax Reform Act provision changing Sec. 707(a)(2).

E. **Sec. 752(c), I.R.C. (Allocations of Partnership Liabilities among Partners for Basis Purposes).**

1. **Perspective** -- The new Sec. 752 Regulations boil down to the simple proposition that, in allocating basis attributable to partnership liabilities among partners, the focus is on the economic risk of loss.

   a. Generally, partnership liabilities are allocated among those partners who will bear the economic risk of loss with respect to those liabilities.

   b. If a person "related" to a partner will bear the economic risk of loss, then, subject to a *de minimis* exception, that partner is deemed to bear the economic risk of loss.

   c. True nonrecourse liabilities (that is, partnership liabilities with respect to which no partner and no person "related" to a partner bears any economic risk of loss) are allocated among the partners in proportion to their shares of partnership profits (as was the case under Reg. §1.752-1(e) prior to the new Sec. 752 Regulations).

2. **Definitions.** For purposes of Sec. 752, I.R.C., the following definitions apply (under Reg. §1.752-1(a)):

   a. **Recourse Liability** -- A partnership liability is a recourse liability to the extent that a partner or related person bears the economic risk of loss for that liability under Reg. §1.752-2.
b. **Nonrecourse Liability** -- A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under Reg. §1.752-2.

c. **Related Person** --

   (1) Under Reg. §1.752-4(b)(1), a related person is a person who bears a relationship to the partner described in Sec. 267(b) or 707(b)(1), I.R.C., with the following modifications:

   (a) substitute "80 percent or more" for "more than 50 percent" each place it appears in those Sections;

   (b) a person's family is determined by excluding brothers and sisters; and

   (c) the affiliated group rules of Secs. 267(e)(1) and 267(f)(1)(A), I.R.C. are disregarded.

Thus, related persons would include:

   (i) A partner and a partnership in which the partner owns 80 percent or more of the capital or profits interest.

   (ii) An individual and a corporation in which the individual owns 80 percent or more of the value of the stock.

   (iii) A husband and wife.

   (iv) A parent and child.

   (v) Two partnerships in which the same persons own 80 percent or more of the capital or profits in interests.

   (vi) A partnership and a corporation having common ownership of 80 percent or more.

   (2) If a person is related to more than one partner, then such person's payment or contribution obligation, or right to reimbursement, is allocated to the partner with the highest percentage of related ownership. If two or more partners are related to such person in the same percentage, then such person's payment or contribution obligation, or right to reimbursement, is allocated equally among such persons. Reg. §1.752-4(b)(2)(i).
(3) Natural persons who are related by virtue of being members of the same family are treated as having a percentage relationship of 100 percent to each other. Reg. §1.752-4(b)(2)(ii).

(4) If related persons directly or indirectly own interests in the same partnership, they are not treated as related persons for purposes of determining the economic risk of loss borne by each of them as to partnership liabilities. Reg. §1.752-4(b)(2)(iii).

(5) A special rule prevents the use of entities to avoid the related person rules, as follows:
   
   (a) If (i) a partnership liability is owed to or guaranteed by another entity that is a partnership, an S corporation, a C corporation or a trust; and (ii) a partner or related person directly or indirectly owns a 20 percent or more ownership interest in the other entity; and (iii) a principal purpose of having the other entity act as a lender or guarantor was to avoid the determination that the partner that owns the interest bears economic risk of loss, then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of the partner's or related person's ownership interest in the entity. Reg. §1.752-4(b)(2)(iv)(A).

   (b) As an example, assume that X, Y and Z form general partnership XYZ, in which they are equal partners, contributing $1,000 each to the partnership. X and Y, who want to lend money to partnership XYZ and have the loan treated as nonrecourse, form new partnership XY, and contribute $50,000 each to the same. X and Y share losses equally in partnership XY. Partnership XYZ borrows $100,000 from partnership XY on a nonrecourse basis, secured by the property which partnership XYZ buys with the loan. Under these facts, X and Y are considered to bear the economic risk of loss with respect to the partnership XYZ borrowing from partnership XY, equally, based on their ownership interests in partnership XY. See Reg. §1.752-4(b)(2)(iv)(C).

(6) Debt is taken into account only once, even though a partner may be liable for such debt both as a partner and in a capacity other than as a partner, such as a guarantor, indemnitor, tenant or borrower. Reg. §1.752-4(c).

3. Assumptions of or Taking Subject to Liabilities.
   a. Increases and Decreases in Partner’s Share of Liabilities -- Under Reg. §1.752-1(b), any increase in a partner’s share of partnership liabilities, or any increase in a partner’s individual liabilities by reason of the partner’s assumption of partnership liabilities, is treated as a contribution of money by that partner to the partnership; and,
under Reg. §1.752-1(c), any decrease in the same is treated as a
distribution of money by the partnership to that partner.

b. **Assumption of Liability** -- Except as
otherwise provided in Reg. §1.752-2(e), a person is considered to
assume a liability only to the extent that:

(1) The assuming person is personally
obligated to pay the liability; and

(2) In the case of any assumption of a
partnership liability by a partner, the person to whom such
liability is owed (x) knows of the assumption and (y) can
directly enforce the partner’s or related person’s obligation
with respect to such liability, and no other partner or related
person to another partner would bear the economic risk of loss
for such liability immediately after the assumption. Reg.
§1.752-2(d).

c. **Property Subject to a Liability** -- If
property is contributed to a partnership by a partner or
distributed by a partnership to a partner, and such property is
subject to a liability of the transferor, the transferee is
considered to have assumed such liability to the extent that the
amount of such liability does not exceed the fair market value of
the property at the time of the contribution or distribution.
Reg. §1.752-2(e).

(1) As an example, assume that A contributes
property with an adjusted basis of $1,000 to a general
partnership for a one-third interest in the partnership. At the
time of contribution, the property is subject to recourse debt of
$150 and has a fair market value in excess of $150. As a result
of the contribution, A’s individual liabilities decrease by $150,
but his share of partnership liabilities increases by $150,
because he is personally liable on the debt and, thus, has
economic risk of loss. There is no net increase or decrease in
A’s individual liabilities and share of partnership liabilities.
Accordingly, A’s basis for his general partner interest is $1,000
(the same as A’s basis for the contributed property).

(2) As a further example, assume that B
contributes property with an adjusted basis of $1,000 to a
general partnership for a one-half interest. At the time of
contribution, the property is subject to nonrecourse debt of
$2,500 and has a fair market value in excess of $2,500. Because
no partner will bear the risk of loss for the nonrecourse
liability, the liability will be a nonrecourse liability of the
partnership. B’s individual liabilities decrease by $2,500, but
B’s share of partnership liabilities increases by $2,000 (that
is, $1,500 allocable to B under Sec. 704(c) if the partnership
were to dispose of the property in a taxable transaction in full
satisfaction of the nonrecourse debt, plus $500, which is B's share of the excess of the nonrecourse liability over the Sec. 704(c) gain). Accordingly, B's basis in his partnership interest is $500, which is the $1,000 basis for the contributed property less the $500 net decrease in liabilities (considered a distribution of money to B).

(3) See Priv. Ltr. Rul. 9015016 (January 9, 1990), where assets were contributed to a partnership by individuals, who expressly agreed in the partnership agreement that they would remain solely liable on the deeds of trust encumbering such assets (and they would indemnify and hold harmless their other partners from any loss on the same). The partnership agreement expressly stated that the partnership did not assume any of the liabilities. Because there was no net change in any of the contributing partners' liabilities resulting from the contribution, there was no deemed distribution (or contribution) of money.

d. Netting of Increases and Decreases in Liabilities Resulting from Same Transaction -- If as a result of a single transaction -- such as a contribution by a partner to a partnership of property subject to a liability or the termination of a partnership under Sec. 708(b), I.R.C. -- a partner incurs both an increase (or decrease) in the partner's share of a partnership liabilities and a decrease (or increase) in the partner's individual liabilities, then

(1) Such increase and decrease must be offset against each other; and

(2) Only the net increase or decrease is taken into account in calculating any contribution of money to the partnership by such partner or distribution of money by the partnership to such partner. Reg. §1.752-2(f).

e. Bifurcation of Liabilities -- If one or more partners bear economic risk of loss for a part, but not all, of a partnership liability, then such liability is considered recourse only to such extent, and is considered nonrecourse as to the remainder thereof. Reg. §1.752-2(h). See Reg. §1.752-2(f), Example 5. See also Rev. Rul. 84-118, 1984-2 C.B. 120.

4. "Recourse" Liabilities.

a. In General -- A partner's share of any recourse liability of the partnership is equal to the portion, if any, of the economic risk of loss for such liability that is borne by such partner. Reg. §1.752-2(a).
b. **Obligation to Make Payment** -- Generally, a partner bears the economic risk of loss for a partnership liability to the extent that the partner or a related person would be obligated to make either (i) a payment to any person or (ii) a contribution to the partnership with respect to such liability, if in either case the partnership constructively liquidated at that time, and the partner or related person would not be entitled to reimbursement from another partner or person related to another partner.

c. **Constructive Liquidation** -- On a constructive liquidation of a partnership, the following events are deemed, under Reg. §1.752-2(b)(1), to occur simultaneously:

1. All of the partnership liabilities become payable in full.
2. All of the assets of the partnership become worthless.

   (a) This excludes money or other separate property contributed by a partner for use by the partnership solely to secure the payment of a partnership liability. Regs. §§1.752-2(h)(1) and (2).

   (b) These assets are treated as though they still belong to the contributing partner if substantially all of the items of income, gain, loss and deduction attributable to the contributed property are allocated to the contributing partner, and this allocation is greater than the partner’s share of any other significant item of the same. Reg. §1.752-2(h)(2).

   (c) A promissory note of a partner or a related person that is pledged or contributed to the partnership is not taken into account unless the note is readily tradeable on an established securities market. Reg. §1.752-2(h)(4).

3. The partnership disposes of all of its property in a fully taxable exchange for no consideration (other than relief of liabilities for which the creditor’s right to repayment is limited solely to one or more assets of the partnership).

4. All items of income, gain, loss and deduction are allocated among the partners.

5. The partnership liquidates.

d. **Treatment on Deemed Disposition** -- On a constructive liquidation, the deemed disposition of the partnership’s assets results in gain or loss as follows (under Reg. §1.752-2(b)(2)): 
(1) Where a creditor's right to repayment of a partnership liability is limited solely to one or more partnership assets, the difference between (x) the amount of the liability extinguished by the deemed disposition and (y) the tax basis in those assets is the recognized gain or loss.

(2) A loss is recognized equal to any remaining tax basis of the partnership's assets.

e. Obligations Recognized --

(1) The facts and circumstances at the time of determination govern as to the extent to which a partner or related person has an obligation to make a payment. Reg. §1.752-2(b)(3).

(2) All statutory and contractual obligations are taken into account. Reg. §1.752-2(b)(3). These include:

(a) Contractual obligations outside the partnership agreement, such as guarantees, indemnifications, reimbursement agreements and other obligations directly to creditors.

(b) Obligations to the partnership under the partnership documents, such as capital contribution requirements and deficit restoration obligations.

(c) Payment obligations imposed by state law.

(3) If an obligation is not recognized under Reg. §1.752-2(b)(3), then it is not considered an obligation to make a payment for any purpose of Reg. §1.752-2(b).

f. Contingent Obligations --

(1) An obligation is disregarded if, under the facts and circumstances, it is subject to contingencies that make it unlikely that the obligation will ever be discharged. Reg. §1.752-2(b)(4). See Albany Car Wheel Co., Inc. v. Comm'r, 40 T.C. 831 (1963), aff'd 333 F.2d 653 (CA2 1964).

(2) If an obligation would arise in the future after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs. See Pierce Estates, Inc. v. Comm'r, 195 F.2d 475 (CA3 1952), and Rev. Rul. 80-235, 1980-2 C.B. 299. See also Reg. §1.752-2(f), Example 8.
g. **Reimbursement Rights** -- A partner's or related person's obligation to make a payment with respect to a partnership liability is decreased to the extent of the right to reimbursement from another partner or a person who is a related person to another partner. Reg. §1.752-2(b)(5).

(1) For this and all other obligation purposes, it is assumed, under Reg. §1.752-2(b)(6), that all partners and related persons with obligations to make payments will actually perform the same, irrespective of their actual net worths, unless the facts and circumstances indicate a plan to circumvent or avoid the situation. (Refer to the anti-abuse rules under Reg. §1.752-2(j)).

(2) See Reg. §1.752-2(f), Examples 3 and 4, as to reimbursement rights under state law.

h. **Recourse Interest on Nonrecourse Liability**

(1) If one or more partners or related persons have guaranteed the payment of more than 25 percent of the total interest that will accrue on any nonrecourse liability of the partnership during its remaining term, and it is reasonable to expect that the guarantor(s) will be required to pay substantially all of the guaranteed future interest if the partnership fails to do so, then each such partner's economic risk of loss is increased by the present value of the remaining interest payments that such partner or related person would be required so to make. Reg. §1.752-2(e)(1). See Reg. §1.752-2(f), Example 7.

   (a) The remainder of the principal amount of the partnership liability constitutes a nonrecourse liability. Reg. §1.752-2(e)(1).

   (b) If, upon a default in payment by the partnership, the lender would not have to foreclose on the property in order to enforce a guaranty, then it is reasonable to expect the guarantor(s) will have to pay substantially all of the guaranteed future interest. Reg. §1.752-2(e)(1).

(2) The present value of any interest payment is determined by assuming that such payment will be made when due and by using a discount rate equal to

   (a) The rate at which such interest payment accrues on the liability; or

   (b) The applicable Federal rate, compounded semi-annually. Reg. §1.752-2(e)(2).
This rule does not apply to a partnership nonrecourse liability if the guarantee of interest by the partner or related person is for a period not in excess of the lesser of (x) 5 years or (y) one-third (1/3) of the term of the lease. Reg. §1.752-2(e)(3).

1. Time Value of Money Considerations -- In determining the extent to which a partner or related person bears the economic risk of loss, there must be taken into account any delay in the time when a payment or contribution obligation with respect to a partnership liability is to be satisfied. Reg. §1.752-2(g)(1).

(1) The obligation is recognized only to the extent of its "value" if either:

   (a) a payment obligation is not required to be satisfied within a reasonable time after it becomes due and payable, or

   (b) a contribution obligation is not required to be satisfied before the later of (i) the end of the year in which the partner's interest is liquidated, or (ii) 90 days after the liquidation. Reg. §1.752-2(g)(1).

(2) The value of a payment or contribution obligation not required to be satisfied within the above time period is considered to be the "face amount" (that is, the entire principal balance) only if the obligation bears interest at least at the applicable Federal rate under Sec. 1274(d), I.R.C. Otherwise, the obligation is discounted to present value under the rules of Sec. 1274, I.R.C. Reg. §1.752-2(g)(2).

j. Anti-Abuse Rules --

(1) The facts and circumstances will be a potential override to arrangements between the parties. Reg. §1.752-2(j)(1).

(2) An obligation of a partner or related person may, thus, be disregarded or treated as an obligation of another person if the facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner's economic risk of loss or to create the appearance of a partner or related person bearing the economic risk of loss when, in fact, the substance is otherwise. Reg. §1.752-2(j)(1).

(3) A number of arrangements are considered tantamount to a guarantee. Ultimately, one must look to the relative economic burdens for the liability under the contractual obligations. Reg. §1.752-2(j)(2).
(4) An obligation of a partner to make a payment is not recognized if the facts and circumstances indicate a plan to circumvent or avoid the obligation. Regs. §§1.752-2(j)(3) and (4), Example.

5. **Partner or Related Person as Lender.**

a. A partner is deemed to bear the economic risk of loss for a partnership liability to the extent that the partner or a related person makes, or acquires an interest in, a nonrecourse loan to the partnership, so long as the economic risk of loss for that liability is not borne by another partner. Reg. §1.752-2(c)(1). Contrast Sec. 465(b)(6), I.R.C.

b. If a partnership liability is owed to a partner or related person and that liability includes (or is "wrapped" around) a nonrecourse obligation encumbering partnership property that is owed to another person, the partnership liability is bifurcated into two separate liabilities, and the wrapped debt is considered owed to another person. Reg. §1.752-2(c)(2). See Reg. §1.752-2(f), Example 6.

c. The general rule above does not apply if (i) the nonrecourse loan is made to the partnership or guaranteed on behalf of the partnership by a partner or related person whose direct or indirect interest in each item of partnership income, gain, loss, deduction or credit for any taxable year is 10 percent or less and (ii) the loan constitutes "qualified nonrecourse financing" under Sec. 465(b)(6), I.R.C. Regs. §§1.752-2(d)(1) and (2). See Reg. §1.752-2(f), Example 5.


a. Under Reg. §1.752-3(a), a partner's share of the nonrecourse liabilities of a partnership equals the sum of

(1) The partner's share of partnership minimum gain under Sec. 704(b), I.R.C. and the Regulations thereunder (see Reg. §1.752-3(b), Example 1);

(2) The amount of any taxable gain that would be allocated to the partner under Sec. 704(c), I.R.C., or in the same manner as under Sec. 704(c) in connection with a revaluation of partnership property, if the partnership, in a taxable transaction, disposed of all partnership property subject to nonrecourse liabilities of the partnership in full satisfaction of such liabilities and for no other consideration; and

(3) The partner's proportionate share of the excess nonrecourse liabilities of the partnership. See Reg. §1.752-3(b), Example 2. [The excess nonrecourse liabilities
equal the excess of the total nonrecourse liabilities of the partnership over those attributed to partnership minimum gain or Sec. 704(c) gain and, as such, allocable to the partners.]

b. The partners generally share nonrecourse liabilities in accordance with their interests in partnership profits. Reg. §1.752-3(a)(3).

(1) In determining the partners' interests in partnership profits, all facts and circumstances relating to the economic arrangement of the partners are taken into account. Reg. §1.752-3(a)(3).

(2) The interests in partnership profits specified in the partnership agreement will govern, so long as the interests so specified are reasonably consistent with allocations (which have substantial economic effect) of some other significant item of partnership income or gain among such partners. Reg. §1.752-3(a)(3).

7. Tiered Partnerships. Where a partnership (the "upper-tier partnership") is a partner in another partnership (the "subsidiary partnership"), the upper-tier partnership's share of the liabilities of the subsidiary partnership -- other than any liability owed by the subsidiary partnership to the upper-tier partnership -- is treated as liabilities of the upper-tier partnership for purposes of applying Sec. 752, I.R.C. to the partners of the upper-tier partnership. Regs. §§1.752-4(a) and 2(i). See also Rev. Rul. 87-115, 1987-2 C.B. 163.

8. Effective Date.

a. In General -- These Proposed Regulations apply to any liability incurred or assumed by a partnership on or after December 28, 1991, other than a liability incurred or assumed by the partnership pursuant to a written binding contract in effect prior to December 28, 1991 and at all times thereafter. Reg. §1.752-5(a).

b. Election -- Whether or not any liabilities have been assumed or incurred during such taxable year, a partnership may elect to apply these Proposed Regulations as of the beginning of the first taxable year of the partnership ending on or after December 28, 1991. Reg. §1.752-5(b)(1).

c. Effect of Partnership Termination under Sec. 708(b)(1)(B), I.R.C. -- A termination of the partnership under Sec. 708(b)(1)(B), I.R.C. will not cause partnership liabilities incurred or assumed prior to the termination to be treated as incurred or assumed on the date of termination. Reg. §1.752-5(c).
F.  **Secs. 1361(b)(1)(D), (c)(4) and (c)(5), I.R.C.**  
(S Corporation Single Class of Stock).

1. **Promulgation** -- On May 28, 1992, new Regulations were finalized with regard to the single class of stock rule as to S corporations.

2. **In General** -- The Regulations specifically address the effect of disproportionate distributions, restricted stock and stock options.

   a. As to disproportionate distributions, the Regulations provide that a second class of stock results only if the stockholders have different distribution or liquidation rights under the terms of the relevant corporate documents, such as the charter, bylaws, applicable state law or other legally binding agreements relating to dividends and liquidation rights. Regs. §§1.1361-1(1)(1) and (2).

   b. Generally, employees holding restricted stock (within the meaning of Reg. §1.83-3(b)) will not be treated as stockholders until the restrictions lapse and their ownership rights in the stock fully vest. Prop. Reg. §1.1361-1(b)(3). This is not the case if the holder of the restricted stock made a Sec. 83(b) election with respect thereto.

   c. A stock option is treated as a second class of stock if, taking into account all the facts and circumstances, such option is "substantially certain" to be exercised and has a strike price "substantially below" the fair market value of the underlying stock on the date the option is issued and on any later transfer or material modification thereof. Reg. §1.1361-1(1)(4)(iii).

   d. A convertible debt instrument is considered a second class of stock if

      (1) it is treated as equity under general principles of Federal tax law relating to debt vs. equity, or

      (2) it embodies rights equivalent to a stock option that is "substantially certain" to be exercised and has a strike price "substantially below" the fair market value of the underlying stock on the date of issue or on any later transfer or material modification thereof. Reg. §1.1361-1(1)(4)(iv).

3. **Debt Safe Harbors** --

   a. Unwritten advances will be considered debt and not a second class of stock, even if considered equity under general principles of Federal tax law, if such debt (1) does not exceed $10,000 per shareholder in the aggregate at any time, (2)
is treated as debt by the parties and (3) is expected to be repaid within a reasonable time. Reg. §1.1361-1(1)(4)(ii)(B)(1).

b. Obligations of the same class held proportionately with the outstanding stock of the corporation are not treated as a second class of stock, even if considered equity under general principles of Federal tax law. Reg. §1.1361-1(1)(4)(ii)(B)(2).

c. Straight debt is not treated as a second class of stock under any circumstances. Reg. §1.1361-1(1)(5)(i).

(1) Straight debt means a written unconditional obligation (whether or not in a formal note), to pay a sum certain on demand, or on a specified due date, which

(a) does not provide for an interest rate or payment dates that are contingent on profits, the borrower’s discretion, or similar factors;

(b) is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; and

(c) is held by an individual (other than a nonresident alien), an estate or a trust qualifying under Sec. 1361(c)(2), I.R.C.

(2) The fact that an obligation is subordinated to other debt of the corporation does not prevent it from qualifying as straight debt. Reg. §1.1361-1(1)(5)(ii).

(3) A material modification or a transfer to a third party who is not an eligible S corporation shareholder causes the straight debt to lose its qualification as such. Reg. §1.1361-1(1)(5)(iii).

4. Effective Date -- These Regulations generally apply to taxable years of a corporation beginning on or after May 28, 1992. However, the corporation and its shareholders may elect to apply the Regulations to prior taxable years.


1. Promulgation -- On April 17, 1992, the Proposed Regulations relating to passive investment income were revised.

2. In General -- Prop. Reg. §1.1362-3(d)(5) defines passive investment income as gross receipts derived from royalties, rents, dividends, interest, annuities and gains from the sales or exchanges of stock or securities.
3. **Exceptions** -- The following are excluded from the passive investment income umbrella:

   a. Royalties derived in the ordinary course of a trade or business of licensing property. This exception applies, however, only if the corporation either (i) created the property or (ii) performed significant services or incurred substantial costs with respect to the development or marketing of the property. Prop. Reg. §1.1362-3(d)(5)(ii)(A)(2).

   b. Rents where the corporation also provides significant services to the user or occupant for the payments. Prop. Reg. §1.1362-3(d)(5)(ii)(B)(2).

      (1) Examples include payments for rooms or other quarters in hotels, boarding houses, apartment houses, tourist homes, motor courts or motels if significant services are rendered.

      (2) Significant services are generally considered rendered to the occupant if they are primarily for the occupant's convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.

      (3) Maid service is considered an example of significant services. However, the cleaning of common areas, the collection of trash and similar activities are not.

      (4) Payments for the parking of automobiles ordinarily are not rents.

   c. Interest on obligations acquired from the sale of property described in Sec. 1221(1), I.R.C. ("dealer" property) or the performance of services in the ordinary course of a trade or business of selling the property or performing the services.

   d. Gross receipts directly derived in the ordinary course of a trade or business of (i) lending or financing, (ii) dealing in property, (iii) purchasing or discounting accounts receivable, notes or installment obligations, or (iv) servicing mortgages. Gain (as well as interest income) with respect to loans originated in a lending business, or interest income (as well as gains) from debt obligations of a dealer in such obligations, constitute gross receipts directly derived in the ordinary course of business.

4. **Effective Date** -- These rules apply to taxable years of S corporations beginning after December 31, 1992. However, for taxable years as to which the statute of limitations has not expired, the S corporation and its shareholders may elect
to apply these Proposed Regulations for S corporation taxable years beginning on or before December 31, 1992, but not for taxable years beginning on or before December 31, 1981.

III. REVENUE PROCEDURES

1. In Rev. Proc. 92-12, 1992-3 I.R.B. 27, the Service set forth its new guidelines for determining when points paid on the financing of a principal residence will be deductible. These guidelines are applicable to tax years beginning after 1990 and are intended to minimize possible disputes over the current deductibility of points. The Service announced that it will treat as deductible points any amounts paid by a cash basis taxpayer during the taxable year in cases where all of the following five requirements are satisfied:

   a. The Uniform Settlement Statement with respect to the property must clearly designate the amounts paid as points incurred in connection with the indebtedness (example: "loan origination fee", "loan discount", "discount points" or "points"). [In Rev. Proc. 92-12A, 1992-26 I.R.B. 20, the Service clarified that amounts so designated on VA and FHA loans qualify under the safe harbor, and stated that Rev. Rul. 67-297, 1967-2 C.B. 87, which provides that VA and FHA loan points are nondeductible service charges, will not apply to cash-method taxpayers who meet the safe harbor requirements under Rev. Proc. 92-12A.]

   b. The amounts must be computed as a percentage of the stated principal amount of the indebtedness incurred by the taxpayer.

   c. The amounts paid must conform to an established business practice of charging points for loans for the acquisition of personal residences in the area in which the residence is located, and the points paid must not exceed the amount generally charged in that area; however, if amounts designated as points are paid in lieu of amounts ordinarily stated separately on the settlement statement, those amounts are not deductible as points.

   d. The amounts must be paid in connection with the acquisition of the taxpayer's principal residence and the loan must be secured by that residence.

   e. The amounts paid as points must be paid directly by the taxpayer claiming the deduction.
2. Rev. Proc. 92-12 is made specifically inapplicable to the following amounts, which are thus nondeductible:

a. Points paid in connection with the acquisition of a principal residence to the extent that such points are allocable to an amount of loan principal in excess of the aggregate amount that may be treated as "acquisition indebtedness" (currently $1 million).

b. Points paid for loans, the proceeds of which are to be used for improvement, rather than acquisition, of a principal residence (the deductibility of which remains governed by Sec. 461(g)(2), I.R.C.).

c. Points paid for loans to purchase or improve a residence that is not the taxpayer’s principal residence.

d. Points paid in connection with a refinancing loan, a home equity loan or a line of credit, even though the indebtedness is secured by a principal residence.

   (1) Such amounts generally are not deductible in the year paid and must be amortized over the term of the loan. See Rev. Rul. 87-22, 1987-1 C.B. 146. It should be noted, however, that any points not deducted, and so remaining at the time of refinancing of a loan become deductible on the pay-off of that refinanced loan.

   (2) Notwithstanding the general rule, the Eighth Circuit has held that points paid by a taxpayer in obtaining a permanent mortgage are deductible immediately. See Huntsman v. Comm’r, 905 F.2d 181 (1990), rev’g 91 T.C. 917 (1988). This result was reached by reliance on the "in connection with" language of Sec. 461(g)(2), I.R.C. The Service has stated that it will not follow Huntsman in Circuits other than the Eighth Circuit. AOD 1991-02.

e. Under Rev. Proc. 92-12A, points paid by the seller of a principal residence to or on behalf of the purchaser. However, where the seller makes any payment to or on behalf of the purchaser, and the parties do not expressly allocate the payment to points, the payment will be allocated, to the extent possible, to expenses other than points.

B. Rev. Proc. 92-20 (Change in Method of Accounting).

Rev. Proc. 84-74 has been superseded by Rev. Proc. 92-20, 1992-12 I.R.B. 10, which will generally be effective for all Applications for Change in Accounting Method (on Form 3115) filed after March 22, 1992. Under the new Revenue Procedure, if a taxpayer waits until being contacted by the Internal Revenue Service as to examination before changing from an impermissible
method of accounting, the terms of a voluntary change are less favorable than before, thus providing an added incentive for voluntary change before such contact.

(1) Change from Category A Accounting Method. If a taxpayer has not been contacted, the spread-forward period for positive adjustments will continue to be up to 3 years, beginning with the year of change, as under Rev. Proc. 84-74. If contact has been made and for a period of 90 days thereafter, the spread forward period remains up to 3 years, but begins with the earliest tax year under examination.

(2) Change from Category B Accounting Method. If a taxpayer has not been contacted, the spread-forward period for positive adjustments is up to 6 years, beginning with the year of change. If a change is made after contact but before the expiration of the 90-day window, any positive adjustment must be bunched into the year of change.

Any change in accounting method after the expiration of the 90-day window is considered imposed as part of the examination. A taxpayer subject to such a change after the expiration of the 90-day window generally has no right to claim the benefit of any spread-forward; accordingly, the entire amount of any positive adjustment may be bunched into the earliest tax year under examination.

C. Rev. Proc. 92-29 (Use of Alternative Cost Method under Sec. 461(h)).

Rev. Proc. 75-25 provided procedures for allowing real estate subdividers to add to the basis of property the estimated cost of future improvements for purposes of determining gain or loss on a sale. The Service indicated in Notice 91-4 that those procedures would remain in effect until the issuance of further rules under Sec. 461(h), I.R.C. In order to address the special circumstances of real estate developers, the Service issued Rev. Proc. 92-29.

Under Rev. Proc. 92-29, 1992-17 I.R.B. 15, a developer may request consent to include in the basis of property sold the allocable share of the estimated cost of common improvements, without regard to whether the costs are incurred under Sec. 461(h). The "estimated cost of common improvements" as of the end of any taxable year is equal to the amount incurred under Sec. 461(h) as of the end of the taxable year, plus the amount of common improvement costs the developer reasonably anticipates it will incur under Sec. 461(h) during the 10 succeeding taxable years.
The alternative cost method prescribed by Rev. Proc. 92-29 is subject to a limitation. As of the end of any taxable year, the total amount of common improvement costs included in the basis of properties sold may not exceed the amount of common improvement costs that have been incurred by the developer with respect to the project under Sec. 461(h). In the event that this limitation precludes the inclusion of the entire allocable share of costs to properties sold, the excluded costs may be taken into account in a subsequent taxable year to the extent that additional common improvement costs have been incurred under Sec. 461(h).

The developer must satisfy the following conditions in order to obtain consent to use the alternative cost method:

1. The developer must be contractually or legally obligated to provide the common improvements, and the cost of such improvements must not be recoverable by the developer through depreciation;

2. The developer must file a request to use the alternative cost method on a project-by-project basis;

3. The developer must sign a consent extending the limitations period for assessment of income tax with respect to the use of the alternate cost method on a project-by-project basis;

4. The developer must file an annual statement for each project for which permission to use the alternative cost method has been granted; and

5. The developer must file a supplemental request for each project for which the developer has received permission to use the alternative cost method.

D. Rev. Proc. 92-33 (Free Transferability of Interests).

In Rev. Proc. 92-33, 1992-17 I.R.B. 28, supplementing Rev. Proc. 89-12, 1989-1 C.B. 798, the Service stated that free transferability of interests will be found not to exist, under Reg. §301.7701-2(e), if, throughout the life of the partnership, the limited partnership agreement expressly restricts the transferability of partnership interests representing more than 20 percent of all interests in partnership capital, income, gain, losses, deductions and credits.


The Service stated in Rev. Proc. 92-35, 1992-18 I.R.B. 21, that, if the bankruptcy or removal of a general partner of a limited partnership causes a dissolution of the partnership unless the remaining general partners or at least a majority in
interest of all remaining partners agree to continuation, the Service will not take the position that the limited partnership has the corporate characteristic of continuity of life.

This statement should be compared to the position taken by the Service in Rev. Proc. 89-12, 1989-1 C.B. 798. That Revenue Procedure provided that the Service would not rule that a limited partnership lacks continuity of life if the partnership agreement permitted less than a majority in interest of limited partners to elect to continue the partnership.

F. Rev. Proc. 92-85 (Extension of Time to Make an Election). In Rev. Proc. 92-85, 1992-42 I.R.B. 32 (advance copy issued October 1, 1992), the Service provides for the automatic grant of an extension of time to make an election where the due date of the election is fixed by the Code, Regulations or other published guidance. An automatic 12-month extension is granted for certain elections the deadlines for which are set forth in Regulations or other published guidance, and a six-month extension is granted for certain elections where the Code itself requires that the election be made only by the due date of the return (or of the return including extensions).

Any tax return, statement of election or other form of filing that must be made to obtain an automatic extension must provide the following statement at the top thereof: "Filed Pursuant to Rev. Proc. 92-85".

Only Regulations issued under certain specified Code Sections are eligible for the automatic extension. These include Secs. 337, 338, 444, 472, 508, 528, 754, 911 and 2032A(d)(1), I.R.C.

In addition, the Revenue Procedure provides a two-step process by which requests for extensions of time are granted for elections that do not meet the requirements for automatic extensions. Applications for relief under this Revenue Procedure will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and when the relief granted would not prejudice the interests of the Service. Regulations issued under Secs. 266, 461(h) and 472, I.R.C., qualify for the new, easier process.

G. Rev. Proc. 92-87 (No Rulings as to Limited Partnership Classification). In Rev. Proc. 92-87, 1992-42 I.R.B. 38, the Service states that it will not ordinarily rule on whether a limited partnership lacks the corporate characteristics of limited liability and continuity of life if the limited partnership (1) is formed pursuant to a state limited partnership act that the Service has determined in a revenue ruling is a statute that corresponds to the Uniform Limited Partnership Act and (2) has the characteristics specified by Rev. Proc. 92-88.
However, where the limited partnership does not fall within the guidelines under Rev. Proc. 92-88, the Service will generally consider a ruling request, as to which the requirements are set forth in Rev. Proc. 89-12, 1989-1 C.B. 798.

H. Rev. Proc. 92-88 (Continuity of Life and Limited Liability). The Service has decided that many of the requests for rulings which it receives regarding the classification of limited partnerships as partnerships for Federal tax purposes do not present a material legal issue needing resolution. Accordingly, the Service has issued Rev. Proc. 92-88, 1992-42 I.R.B. 39, setting forth guidelines under which a limited partnership will be treated as lacking the corporate characteristics of continuity of life and limited liability. A limited partnership satisfying these guidelines will be treated as a partnership for Federal tax purposes and does not ordinarily need to request a classification ruling.

The general requirements generally follow Sections 4.01, 4.02 and 4.03 of Rev. Proc. 89-12. They are as follows:

1. The general partners, taken together, must have at least a 1 percent interest in each material item of partnership income, gain, loss, deduction or credit at all times during the life of the partnership. However, the 1 percent requirement drops proportionately -- but not below 0.2 percent -- as total contributions exceed $50 million.

2. The general partners, taken together, must maintain, at all times, a minimum capital account balance equal to either 1 percent of the total positive capital account balances for the partnership or $500,000, whichever is less, unless no limited partner capital account has a positive balance.

As to continuity of life, a limited partnership is treated as lacking the same if it is formed under a state limited partnership act that has been determined in a revenue ruling to correspond to the Uniform Limited Partnership Act. See Rev. Rul. 89-123, 1989-2 C.B. 261 (and any Revenue Rulings that supersede or amplify the same) for a list of states that have enacted legislation that corresponds to the ULPA.

As to limited liability, a limited partnership must satisfy the net worth requirements set forth below on a continuing basis. (In determining net worth, assets are valued at their current fair market value.) A limited partnership cannot rely on Rev. Proc. 92-88 for any period of time subsequent to the failure to meet the net worth standard.
1. If the sole general partner is a corporation, its net worth must equal or exceed 10 percent of the total contributions to the partnership. (Any interest in the partnership is not included.) If there are two or more corporate general partners, the net worth may be met on a collective basis.

2. If the sole general partner is an individual, that partner's net worth must equal or exceed the lesser of 10 percent of the total contributions to the partnership or $1,000,000. (Any interest in the partnership is not included.) If there are two or more individual general partners, the net worth may be met on a collective basis.

3. If the general partners include one or more corporations and one or more individuals, the net worth test may be met either by the corporation(s) and individual(s), on a collective basis, meeting the corporate test above or by all the individual(s) collectively meeting the individual test above.

4. In determining the net worth of the general partners, the value of property included in determining the net worth of one general partner may not be taken into account in determining the net worth of any other general partner. (E.g., a parent corporation and wholly-owned subsidiary both serving as general partners of a partnership.)

IV. REVENUE RULINGS

A. Rev. Rul. 91-31, 1991-1 C.B. 19. The Service ruled that a reduction in the unpaid principal amount of a nonrecourse debt results in the realization of discharge of indebtedness income by the debtor, irrespective of whether the fair market value of the property is greater or less than the balance of the debt at the time of the principal reduction.

The holding in this Ruling amplified Rev. Rul. 82-202, 1982-2 C.B. 35, in which the Service ruled that a reduction in debt, whether recourse or nonrecourse, results in the realization of income by the debtor under Sec. 61(a)(12), I.R.C., if, at the time of the reduction, the fair market value of the property is greater than the principal balance of the debt.

The Service expressly rejected the holding in Fulton Gold Corp. v. Comm’r, 31 B.T.A. 519 (1934), in which the Board of Tax Appeals held that the satisfaction of a nonrecourse mortgage for an amount less than its face amount results in a reduction of the mortgagor’s basis in the underlying property rather than the realization of income. See also Comm’r v. Tufts, 461 U.S. 300 (1983); and Gershkowitz v. Comm’r, 88 T.C. 984 (1987). But see, for a variation on Gershkowitz, Newman’s Estate v. Comm’r, 934 F.2d 426 (CA2 1991), rev’g 59 TCM 543 (1990).
B. Rev. Rul. 91-47, 1991-2 C.B. 757. The Service held that where a person unrelated to a debtor forms or avails of a corporation to acquire the debtor’s debt and shortly thereafter sells all of the stock of the new corporation to the debtor, the debtor realizes discharge of indebtedness income under Sec. 61(a)(12), I.R.C. Such income can, however, be excluded under Sec. 108(a), I.R.C., if (1) the discharge occurs in a title 11 case (Secs. 108(a)(1)(A) and (d)(2), I.R.C.), (2) the debtor is insolvent both before and after the discharge (to the extent of the insolvency) (Secs. 108(a)(1)(B) and (3) and (d)(3), I.R.C.), or (3) the debt is qualified farm indebtedness (Secs. 108(a)(1)(C) and (g), I.R.C.).

In this Ruling, it was specified that the unrelated party (“P”) (1) may or may not have held debt of the debtor (“D”); (2) learned that D was seeking to reduce its debt; (3) discussed with D the formation of a corporation to acquire D’s debt and the subsequent sale of the stock of such corporation to D; (4) anticipated (as did D) that acquiring the debt of D through such corporation would allow D to avoid the discharge of indebtedness income that D would have had if D had acquired the debt itself directly or through a related party; (5) had no important business purpose for the formation of the new corporation other than to acquire D’s debt; and (6) ordinarily did not acquire stock or debt through a special-purpose corporation in making acquisitions on behalf of, or for resale to, unrelated persons.

The Service, using both step-transaction and form versus substance (or business purpose) analyses, found that the substance of the transaction controls to prevent the avoidance of Secs. 61(a)(12) and 108(e)(4), I.R.C. The Service noted that, because P’s formation of the new corporation to acquire D’s debt did not serve an [otherwise] important business purpose and was for the primary purpose of avoiding the discharge of indebtedness income that D would realize if it acquired its debt directly or through a related party, P’s ownership of the new corporation is disregarded. Accordingly, the transaction entered into by D and P is treated as though D in fact acquired its debt from P directly or through a related party.

C. Rev. Rul. 92-2, 1992-3 I.R.B. 5. The purchaser of a principal residence is often charged points. In cases where the financing is obtained from a lender through a mortgage broker, some portion of the amount charged as points may be paid directly or indirectly to the broker. The Service ruled that all points received directly or indirectly by a mortgage broker in connection with the financing of the purchase of a principal residence are reportable under Section 6050H to the same extent as if paid to and retained by the lender.
D. Rev. Rul. 92-17, 1992-12 I.R.B. 5. D corporation was the general partner of a limited partnership ("LP"), owning a 20 percent interest therein. LP owned, for more than 5 years, several commercial office buildings that were leased to unrelated third parties. D owned its interest in LP for more than 5 years. D also owned, for more than 5 years, all of the stock of C, a corporation actively engaged for more than 5 years in the conduct of a trade or business unrelated to D’s activities.

As the general partner of LP, D was required to provide the managerial services necessary to operate the rental business of LP. LP provided day-to-day upkeep and maintenance services for the office buildings, advertising for new tenants, negotiating leases, handling tenant complaints and paying all expenses. LP also periodically repainted and refurbished its existing properties. D’s officers performed active and substantial management functions with respect to LP’s activities. In addition, D’s officers regularly participated in the overall supervision, direction and control of LP’s employees in their performance of LP’s general functions.

Although D did not itself have employees to perform the operational services necessary to operate LP’s office buildings, the Service nonetheless found that a spin off of all of the C stock to D’s shareholders met the active conduct of a trade or business test of Sec. 355(b), I.R.C., and therefore qualified as a tax-free distribution under Sec. 355, I.R.C. The Service, in its conclusion, harkened back to its similar conclusion in Rev. Rul. 79-394, 1979-2 C.B. 141, amplified by Rev. Rul. 80-181, 1980-2 C.B. 121.

E. Rev. Rul. 92-20, 1992-13 I.R.B. 18. A transferred shares of X, an S corporation, to a trust. The trust instrument provides that all trust income is to be distributed to B, the trust beneficiary, on at least an annual basis. It is further provided, however, that, if the trust no longer holds shares of X or any other S corporation, the trustee may distribute trust income or accumulate such income, adding it to the trust corpus. Any trust income remaining undistributed at the time of B’s death would be paid over to B’s estate. The Service ruled that the provision authorizing accumulation of trust income in the event that the trust does not hold shares of an S corporation does not, alone, preclude qualification of the trust as a QSST.

F. Rev. Rul. 92-52, 1992-27 I.R.B. 6. This Revenue Ruling provides guidance for insolvent corporate taxpayers who provide cash or other property, as well as stock, to their creditors in exchange for the cancellation of debt, where the resolution is outside of a title 11 case.
In the first situation, X corporation owes an unsecured debt of $90,000 to an unrelated creditor. X has assets with a fair market value of $40,000, and so is insolvent in the amount of $50,000. In 1992, X issues $10,000 of its debt and $20,000 of its common stock to the creditor in exchange for the $90,000 of debt. Accordingly, X has $60,000 of discharge of indebtedness. However, because of the $50,000 of insolvency immediately before the discharge, X only has $10,000 of COD income. Under the legislative history of the 1980 Bankruptcy Tax Act (see S.Rep. No. 1035 at 17, 1980-2 C.B. at 629), where a corporate debtor issues a package of stock and other property to cancel debt, the cash and other property are treated, first, as satisfying an amount of debt equal thereto, with the remainder of the debt being treated as satisfied by the stock issuance. Accordingly, under Sec. 108(e)(10), I.R.C., no reduction of the corporation's tax attributes is required under Secs. 108(a) and 1017, I.R.C.

In the second situation, Y has unsecured debt to A of $30,000 and to B of $60,000. Both A and B are unrelated to Y. In 1992, Y issues $10,000 of debt to A in exchange for its debt to A and common stock with a fair market value of $20,000 to B in exchange for its debt to B. As to A, Y has $20,000 of discharge of indebtedness, and as to B, Y has $40,000 of discharge of indebtedness. However, because of the $50,000 of insolvency immediately before the discharge, Y only has $10,000 of discharge of indebtedness income. When determining the potential tax attribute reduction of an insolvent debtor outside of a title 11 case, the discharge of indebtedness attributable to insolvency is first allocated to stock-for-debt exchanges, with any remaining discharge of indebtedness attributable to insolvency allocated to any other exchanges. Because the stock-for-debt exchange applies first, so that Sec. 108(e)(10), I.R.C. applies, that $40,000 discharge does not result in any attribute reduction. However, as to the debt-for-debt exchange, the $10,000 discharge is governed by Sec. 108(b) and 1017, I.R.C.

G. Rev. Rul. 92-53, 1992-27 I.R.B. 7. The Service holds, in dealing with three situations in this Ruling, that the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, a taxpayer is insolvent under Sec. 108(d)(3), I.R.C., but only to the extent that the "excess nonrecourse debt" is discharged.

In all three situations, there was no bankruptcy or qualified farm indebtedness, so that the specific exclusions of Secs. 108(a)(1)(A) and (C), I.R.C. do not apply.

In situation 1, individual A borrowed $1,000,000 from C in 1988 and signed a nonrecourse note for such amount, secured by an office building with a value in excess of $1,000,000 which A purchased with the loan proceeds. In 1989, when the building's
value has fallen to $800,000, C agreed to reduce the note to $825,000. At that time, A's only other assets had a fair market value of $100,000, and A was personally liable to D for $50,000.

In situation 2, the facts are the same, except that D agreed to accept assets from A with a fair market value (and basis to A) of $40,000 in settlement of A's recourse debt to D of $50,000, but C did not reduce the nonrecourse debt.

In situation 3, the facts are the same as in situation 1, except that, pursuant to a pre-arranged workout plan, D accepted the assets of $40,000 in settlement of A's $50,000 debt and shortly thereafter C reduced the nonrecourse note to $825,000.

In situation 1, A has $1,025,000 of liabilities, comprised of (i) the $50,000 of recourse debt, (ii) the $800,000 of nonrecourse debt equal to the fair market value of the building and (iii) the $175,000 ($1,000,000 less $825,000) of excess nonrecourse liability discharged. A's $1,025,000 of liabilities exceed A's assets of $900,000 ($800,000 building plus $100,000 other assets) by $125,000 immediately before the debt discharge, and so A is insolvent by such $125,000. Therefore under Secs. 108(a)(1)(B) and (3), I.R.C., $50,000 of the $175,000 discharged debt ($175,000 less $125,000) is COD income under Sec. 61(a)(12), I.R.C.

In situation 2, only $10,000 of recourse debt, but no excess nonrecourse debt, is discharged, and so the excess nonrecourse debt is not taken into account at all in determining A's insolvency under Sec. 108(d)(3), I.R.C. A is therefore solvent immediately before the discharge because its liabilities of $850,000 ($800,000 building debt (limited to building fair market value) and $50,000 recourse debt) do not exceed its $900,000 fair market value of assets ($800,000 building and $100,000 other assets). Thus, the entire $10,000 of discharged debt is income under Sec. 61(a)(12), I.R.C.

In situation 3, A has $185,000 ($10,000 recourse debt and $175,000 nonrecourse debt) discharge of indebtedness. Because of the prearranged plan, the discharges are viewed as occurring simultaneously, but only for determining whether, and to what extent, A is insolvent under Sec. 108(d)(3), I.R.C. As a result, A has $60,000 of COD income under Sec. 61(a)(12), I.R.C., determined as set forth under situations 1 and 2.

In Rev. Rul. 92-53, the Service distinguishes Rev. Rul. 91-31, supra, on the basis that Rev. Rul. 91-31 deals with discharge of indebtedness income under Sec. 61(a)(12), I.R.C., but does not address the treatment of nonrecourse indebtedness in applying the Sec. 108 insolvency exclusion. Does such distinction hold up under close scrutiny? See Lipton, IRS Adopts

H. Rev. Rul. 92-92, 1992-45 I.R.B. A, an individual defaults on a recourse loan from an unrelated bank when the outstanding unpaid balance is $1,000,000. A transfers property with an adjusted basis of $700,000 and a fair market value of $800,000 to the bank in full satisfaction of the debt. As a result, A has $200,000 of COD income ($1,000,000 recourse liability less $800,000 value of property transferred) and $100,000 of disposition income ($800,000 value of property less $700,000 adjusted basis). The COD income is not excluded from A's income under Sec. 108, I.R.C. At the time of discharge of indebtedness, under Temp. Reg. §1.163-8T, dealing with debt tracing, 60 percent of the debt is allocated to passive activity expenditures and 40 percent is allocated to other expenditures.

As noted by the Service, "it is generally appropriate to allocate the income in the manner in which Section 1.163-8T of the temporary regulations allocates the debt at the time of the discharge and to treat the income allocated to an expenditure as income from the activity to which the expenditure relates. However, traditional substance over form and step transaction principles will apply to prevent taxpayers from attempting to manipulate the character of COD income."

V. PRIVATE LETTER RULINGS

A. Priv. Ltr. Rul. 9125010 (March 19, 1991). An individual taxpayer, X, proposed to enter a transaction pursuant to which one of X's creditors would, in exchange for a cash payment, discharge X's liability to it. X was not in a title 11 proceeding. X inquired as to whether the value of his personal residence and other property exempt under state law from the grasp of creditors would be disregarded in determining the taxpayer's "insolvency" for purposes of the exception under Secs. 108(a)(1)(B) and (3) and (d)(3), I.R.C.

The Service held that the taxpayer's personal residence and other property exempt from creditors under state law should be disregarded in the determination, of the extent to which the taxpayer was insolvent. See Marcus' Estate v. Comm'r, 34 TCM 38 (1975), and Hunt v. Comm'r, 57 TCM 919 (1989). See also Dallas Transfer & Terminal Warehouse Co. v. Comm'r, 70 F.2d 95 (CA5 1934), and Lakeland Grocery Co. v. Comm'r, 36 B.T.A. 289 (1937).

B. Priv. Ltr. Rul. 9128024 (April 12, 1991). Apartment buildings which decedent owned directly (in whole or in part) or indirectly (through corporations or a general partnership) were found by the Service to constitute interests in a closely held business under Sec. 6166(b), I.R.C.
The Service noted that decedent's activities (assisted by his son, a handyman and a garbage remover, all of whom could be viewed as agents of decedent) went beyond merely collecting rents, making mortgage payments and making necessary repairs, which are considered investment management. The day-to-day operations and management were handled by decedent, who directly or through his agents, did everything from interviewing and screening prospective tenants, to negotiating leases, to maintaining all common areas, to painting, to paying bills, to inspecting buildings, to resolving complaints from tenants and mediating tenant disputes.

The Service further noted that decedent was on call 24 hours a day (including weekends) for emergencies or urgent repairs, and that decedent had no source of earned income other than from the management of the real estate interests.

C. Priv. Ltr. Rul. 9146043 (August 20, 1991). Corporation X and wholly owned subsidiary Z engaged in the active conduct of a trade or business involving the rental of commercial office, warehouse and parking space. The shares of X were owned equally by A and B. To eliminate problems generated by disputes between A and B, X proposed to distribute its Z stock to B in exchange for B's X stock. After the proposed transaction, A would own all of the X stock and B would own all of the Z stock. The Service held that, under the facts presented, no gain or loss should be recognized by X upon distribution, or by B upon receipt, of Y stock. After the contemplated distribution, the basis of the Y stock in B's hands will be the same as the basis of the surrendered X stock and tacking will apply in determining the holding period for the stock.

D. Priv. Ltr. Rul. 9148013 (August 23, 1991). The taxpayer, an S corporation, owns, installs and leases trailers and relocatable modular offices for use at construction sites. In connection with such leasing transactions, the corporation remolds the units to customer specifications, provides assistance in the installation and set-up of such units, and services, maintains and repairs the units during the lease term. The corporation also leases and services portable toilets, temporary power poles and construction sheds.

The income generated by leasing activities is generally characterized as "rents". The Service recognized, however, that income from leasing personal property which is delivered and maintained by the owners does not constitute "rents" for the purpose of characterization of such income as passive investment income. Accordingly, the Service ruled that the income realized by the corporation from such leasing activities does not constitute disqualifying " passive investment income" which would result in the termination of an S election.
E. Priv. Ltr. Rul. 9148025 (August 26, 1991). Taxpayer transferred all assets of a mobile home park, except for the underlying land, to a wholly owned corporation. The corporation leased the land from taxpayer. In connection with the operation of a nearby airport, the city claimed a navigation easement over the land. The city refused to condemn the property, electing instead to impose restrictive covenants upon the property. The property was then returned to the taxpayer, subject to the imposed restrictive covenants which made the land uninhabitable.

The Service held that the proceeds from a subsequent sale of the land would constitute proceeds from an involuntary conversion and that any new land acquired by the taxpayer and improved for purposes of use as a mobile home park would constitute qualified replacement property under Section 1033. The taxpayer was found to be entitled to the benefits of Section 1033, notwithstanding the fact that the city refused to acquire the property, but instead imposed restrictions on its use which were incompatible with taxpayer’s use of the property, which had continued for a period in excess of 30 years. Section 1033 was ruled to be applicable in this case even though the taxpayer retained title to the property and the subsequent sale was to private parties.

F. Priv. Ltr. Rul. 9149009 (August 29, 1991). Taxpayer purchased lessee’s interest in a safe harbor lease agreement, taking property subject to the lease. Taxpayer then leased the property to the lessee, with such leasing activity being the sole activity of taxpayer. The Service agreed with the taxpayer that such leasing activity is a passive activity within the meaning of Sec. 469(c), I.R.C. Accordingly, the Service concluded that the items of income and deduction associated with the safe harbor lease are to be taken into account for purposes of determining taxpayer’s passive activity loss, if any, for the taxable year. The Service ruled that taxpayer’s deductions for rent expense and leasehold amortization under the safe harbor lease may be recognized as passive deductions. The Service further ruled that all interest income realized by taxpayer on an installment note given under the safe harbor lease must be recognized as portfolio income.

G. Priv. Ltr. Rul. 9149018 (September 4, 1991). Corporation X owns an office building which has a fair market value in excess of its adjusted basis. X plans to transfer the building only in an exchange transaction in which X will designate property upon which a new building will be constructed, followed by an exchange of the existing building for the newly constructed building. The existing building is used by X in its business, and it will acquire the new building, along with the lease agreement, to be used in such business. The rights of X to participate in the development and construction of the building are extensive. (The Service found this to be acceptable, citing
Furthermore, X is furnishing the financing, on a nonrecourse basis, to construct the project. (The Service approved this technique, under the authority of 124 Front Street, Inc. v. Comm'r, 65 T.C. 6 (1975).) Because the lease will have a remaining term of 30 years or more at the time of the exchange, it qualifies for like-kind exchange treatment under Reg. §1.1031(a)-1(c)(2).

H. Priv. Ltr. Rul. 9213001 (November 27, 1991). X is an S corporation formed to market and sell weekly timeshare condominium units in a certain geographic area. In 1986, X purchased two non-contiguous condominium projects. During 1986 and 1987, X converted, marketed and sold these residences as resort timeshare units on a fee simple, week-interval ownership basis. The purchaser made a small downpayment at the time of sale, with the balance payable in monthly installments. X reported its income from sales of one project on the installment method, and of the other project on an accrual method. The Service found that, under Secs. 446(c) and 453(d)(1), I.R.C., the taxpayer was not required to report all sales under the installment method. The Service further found that, under Sec. 453C, I.R.C., the sales from February 28, 1986 through December 31, 1987 were applicable installment obligations as to which an election to be taxed on the installment method had not properly been made. Accordingly, any deferred gain at January 1, 1988 had to be recognized by X in two equal annual amounts, in each of 1988 and 1989.

I. Priv. Ltr. Rul. 9217010 (January 13, 1992). Taxpayer entered into four separate agreements with four different owners to purchase land parcels B, C, D and E. Prior to the closing date for all four purchases, the taxpayer entered into a new purchase and sale agreement to sell the four parcels to a joint venture, organized for the purpose of purchasing and developing the four parcels. The selling price to the joint venture was subject to adjustment in case a certain number of condominium units were not approved by the appropriate governmental entities. After the purchase and sale agreement with the joint venture was executed, the taxpayer entered into negotiations with the joint venture to repurchase the four parcels, with plans to sell the four parcels to a third party. Thereafter, the joint venture acquired title to the four parcels and held them for about 120 days, at which time the joint venture transferred title to the taxpayer, which itself developed the property.

The taxpayer reported the entire transaction as a financing transaction, rather than a sale and repurchase of property. The Service stated that "the key to deciding whether Taxpayer's transactions with Joint Venture were a sale and repurchase or a loan is to determine whether the benefits and burdens of ownership passed from Taxpayer to Joint Venture during
the 120-day period that Joint Venture held title to the four parcels." Citing Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221 (1981), the Service considered eight factors, as follows: (1) whether legal title to the property passes; (2) how the parties treated the transaction; (3) whether equity was acquired in the property; (4) whether the agreement created an obligation on the seller to execute and deliver a deed and an obligation on the purchaser to make payments; (5) whether the right of possession was vested in the purchaser; (6) which party paid the property taxes; (7) which party bore the risk of loss or damage to the property; and (8) which party received the profits from the sale of the property. Based on such factors, the Service found that the joint venture was not a financier for the taxpayer, but rather that there was a true sale and repurchase of the property.

J. Priv. Ltr. Rul. 9218078 (January 31, 1992). A limited liability company organized under the Texas Limited Liability Company Act was classified as a partnership for Federal income tax purposes. Because the LLC would dissolve on the death, retirement, resignation, expulsion, bankruptcy or dissolution of one of its members, unless the remaining members (all or such lesser number as stated in the articles of organization or regulations of the LLC) consented to continue the organization, the LLC lacked continuity of life. Further, because no transferee had the right to become a substituted member unless consent was given by the manager (who had to be a member of the LLC) or members owning at least two-thirds of the outstanding units (excluding the transferred unit), which consent could be withheld in the discretion of the manager or the members, the LLC lacked free transferability of interests.

K. Priv. Ltr. Rul. 9224006 (March 5, 1992). T owns 99 percent of the capital and profit interests of B, 79.7% of P and 98.75% of C. T, B, P and C are all limited partnerships. On July 3, 1989, B acquired a 5.5 acre tract of real property to be held for investment and future development and for operating a surface parking lot on the property. The tract was sold to the county under the threat or imminence of condemnation. B proposes to acquire tracts of improved and unimproved real property from P and C as replacements for the tract sold to the county. The replacement tracts will be acquired at their fair market values, as determined by an independent appraiser; will be held for productive use in a trade or business or for investment; and will be of a like-kind with respect to the tract sold to the county. The replacement tracts will be acquired within three years of the sale to the county, as required by Sec. 1033(g)(1), I.R.C. Citing Rev. Rul. 73-120, 1973-1 C.B. 369, involving an apartment complex purchased by an S corporation from its shareholders in an arm’s-length transaction, the Service found that, so long as an arm’s-length purchase price is paid for the replacement tracts,
the transaction will qualify under Secs. 1033(a)(2)(A) and 1033(g), I.R.C.

L. Priv. Ltr. Rul. 9224025 (March 13, 1992). P will be organized as a limited partnership under the Revised Uniform Limited Partnership Act of State N. X, an S corporation also formed in State N, will be the sole general partner of P. The sole shareholders of X are A and B, who are sister and brother. The limited partners of P will be A, B and Y, a State N corporation, the shares of which are directly and indirectly owned by a family that includes A, B, the mother of A and B, and trusts for the benefit of the children of A and B. Because P will be organized under a statute corresponding to the Uniform Limited Partnership Act, P will lack of continuity of life. Because the limited partnership agreement of P provides that all partners must approve an assignee of a limited partnership being admitted as a substituted limited partner, there is no free transferability of interests. Accordingly, P will be classified as a partnership for Federal income tax purposes.

M. Priv. Ltr. Rul. 9226035 (March 26, 1992). The Service found that the conversion of a general partnership into a limited liability company could take place generally without adverse Federal income tax consequences. The conversion is to be effected by a contribution of the interests of the members of the general partnership to the LLC in exchange for all of the ownership interests in the LLC, followed by a dissolution of the general partnership and distribution of all of its assets to the LLC, which will assume all of the recourse obligations and take subject to all of the nonrecourse obligations of the general partnership. The LLC will be classified as a partnership for Federal income tax purposes because it will lack the characteristics of free transferability of interests and continuity of life.

Citing Rev. Rul. 84-52, 1984-1 C.B. 157, the Service found that (1) under Sec. 721, I.R.C. no gain or loss will be recognized by the members, the general partnership or the LLC on the transfer of the interests in the general partnership to the LLC or the liquidation of the general partnership, except as provided in Sec. 752, I.R.C.; and (2) the LLC will be considered a continuation of the general partnership, and so the conversion of the general partnership into the LLC will not be considered a sale or exchange (under Reg. §1.708-1(b)(1)(ii)) and will not result in a termination of the general partnership under Sec. 708, I.R.C.

N. Priv. Ltr. Rul. 9238005 (June 8, 1992). Prior to June 22, 1981, Y was a corporation wholly owned by corporation X; X was a corporation wholly owned by individual A; and W was a corporation wholly owned by A's daughter ("D") and two trusts ("trusts") created for the benefit of A's two granddaughters. On
June 22, 1981, X sold to W all of the Y stock in consideration for a 20-year promissory note (the "Note"). The Note was collateralized by a security agreement between X and W, pursuant to which X received a security interest in all the Y stock and all the stock in two wholly owned subsidiaries of Y, and these shares were deposited with X. On June 25, 1982, X distributed all of its assets (including the Note) to A pursuant to a plan of complete liquidation under Sec. 337, I.R.C. 1954. In 1982 and 1983, W made its annual payments on the Note to A. On March 15, 1983, W, Y and Y's two subsidiaries adopted plans for complete liquidation under Sec. 337, and Y sold most of its assets and the assets of its two subsidiaries for cash and the assumption of certain liabilities. On March 15, 1984, Y and its two subsidiaries distributed all their assets (primarily cash) and liabilities to W, which, in turn, distributed all of its assets and liabilities to D and the Trusts, all pursuant to the plans of complete liquidation.

The sale and complete liquidations changed A's collateral for the Note from the shares of stock of Y and its two subsidiaries to cash, publicly traded stocks and bonds and real estate. Moreover, the obligor in the Note was changed from W to D and the Trusts. Citing Rev. Rul. 55-5, 1955-1 C.B. 331, the Service found that the substitution of collateral securing an installment obligation does not constitute a disposition under Sec. 453B(a), I.R.C. Citing Cunningham v. Comm'r, 44 T.C. 103 (1965), and Rev. Rul. 75-457, 1975-2 C.B. 196, amplified by Rev. Rul. 82-122, 1982-1 C.B. 80, the Service found that the substitution of a new obligor on the Note likewise did not constitute a disposition.

However, under Temp. Reg. §15a.453-1(b)(3)(i), the Service held that the portion of the collateral consisting of cash or equivalents was considered a payment on the Note, causing recognition of any gain inherent in that payment.

O. Priv. Ltr. Rul. 9238034 (June 23, 1992). X, an S corporation with 35 shareholders, has two businesses. One is the provision of management, payroll, billing and collection services to health care providers. The second is a facility at which outpatient surgery is performed. The shareholders want to expand the surgery center; they need additional capital for the expansion, and are willing to offer an equity position in the expanded facility to new investors. However, the shareholders do not want to share with new investors the other, distinct business of X. They think that business has real potential for growth on its own and should be retained by the original risk takers.

X proposes to form a limited partnership ("LP") to own and operate the surgery center. X will contribute to LP the assets of its surgery center business, including trade receivables, a share of fixed assets and debt, in exchange for a
general partner interest. Limited partner investments in LP will be offered to potential investors. X will have a ___ percent interest in the profits of LP, and the investors will have the remainder. X will provide LP with management, personnel, payroll, billing and collection services.

The Service held that ownership of an interest in the partnership would not preclude X from maintaining its S corporation status. The Service relied on Rev. Rul. 71-455, 1971-2 C.B. 318, and Patterson v. Comm'r, 47 TCM 1029 (1984). The Service also found that, in contradistinction to Rev. Rul. 77-220, 1977-1 C.B. 263, this was not a ploy to circumvent the 35 shareholder limitation of Sec. 1361(b)(1)(A), I.R.C., because of the valid business purpose for the proposed transaction.

P. Priv. Ltr. Rul. 9239014 (June 25, 1992). Mr. and Mrs. A, husband and wife, propose to form a limited partnership and place their business into it. The business is currently operated by Mr. and Mrs. A, and all of its assets are either in their separate names or held by them as joint tenants. The general partner will be a corporation, all of the stock of which is owned by Mr. A. The general partner will have a one percent interest in the partnership, and Mr. and Mrs. A will be the sole limited partners, each owning a 49.5 percent interest. The Service found that the limited partnership will be classified as a partnership for Federal income tax purposes because it will lack the corporate characteristics of continuity of life and free transferability of interest. As to free transferability, no limited partner may, under the partnership agreement, transfer any portion of his or her limited partner interest in any manner that results in the transferee becoming a substitute limited partner without the prior written consent of the general partner.

Q. Priv. Ltr. Rul. 9240004 (June 29, 1992). Taxpayer is a corporation engaged in the manufacturing and sale of a product. Taxpayer operates a facility in State N which contains equipment used in the processing and manufacturing of such product. The equipment, which was manufactured prior to the 1980s, is insulated with asbestos. Both State N and the Occupational Safety and Health Administration set standards, affecting the taxpayer, for concentrations of airborne asbestos fiber allowable in the work place. In response thereto, and in order to afford its workers the necessary health and safety protection, taxpayer decided to remove the asbestos insulation from its equipment in the State N facility and replace it with alternative insulating materials.

The taxpayer has stated that the new replacement insulation is about 10 percent less thermally efficient than the asbestos insulation, and thus does not save energy or effect other operating efficiencies, other than health and safety. In addition, the total cost of removal, although significant, is
minor in relation to the facility’s overall repair and maintenance costs and in relation to the assessed value of the equipment for property tax purposes. Consequently, the taxpayer has currently deducted the costs incurred to remove asbestos insulation and to install new insulating materials into its manufacturing equipment.

The Service found that the taxpayer must capitalize its asbestos costs under Sec. 263, I.R.C. (for taxable years beginning prior to January 1, 1987) or Sec. 263A, I.R.C. (for taxable years beginning after December 21, 1986). The Service noted that "the costs incurred by the taxpayer for removal and replacement of asbestos-containing insulation are not similar to incidental repairs. Rather, these costs are more in the nature of capital expenditures because, by reducing or eliminating the human health risks posed by the presence of asbestos, these expenditures increase the value of the taxpayer’s equipment. Specifically, the taxpayer's risk of liability to contaminated employees is decreased. Moreover, asbestos removal makes the taxpayer’s property more marketable. Generally, property without asbestos is more attractive to potential buyers, investors, and lenders. In fact, the lending policies of several financial institutions favor, and sometimes require, asbestos removal. **

Thus, property from which asbestos has been removed and replaced is inherently more valuable than property that contains asbestos insulation."

The Service cited, among other cases, INDOPCO, Inc. v. Comm’r, 112 S.Ct. 1039, 92-2 USTC ¶50,113 (1992), where, the Service stated, the "Court noted that, in determining whether an expenditure is capital in nature, an important consideration is whether the taxpayer realizes benefits beyond the year in which the expenditure is incurred." The Service pointed out that, in its view, "the taxpayer’s asbestos removal costs create long-term future benefits that accrue beyond the year that they were incurred. In addition, these future benefits are not merely incidental. In fact, they relate to the very reason for incurring the expense [ -- ] increased health and safety."

VI. CASES

A. Aizawa v. Comm’r, 99 T.C. ___, No. 10 (1992). The taxpayers owned rental property which they purchased in 1981 for $120,000 plus $433 in closing costs, giving the sellers a $90,000 interest-only recourse mortgage rate at closing. The entire unpaid principal balance of the note was due in full in June 1985, but the taxpayers did not pay it. In 1987, the sellers obtained a $133,506.91 judgment against the taxpayers, consisting of the $90,000 unpaid principal, $18,000 accrued but unpaid interest, $25,000 legal fees and $500 court costs. Later in 1987, the sellers purchased the property at a foreclosure sale
for $72,000, leaving an unsatisfied deficiency judgment of $66,806.71.

The taxpayers claimed a loss of $70,898.29 on their 1987 tax return, determined by subtracting the amount of $29,193.09 from their basis at the time of foreclosure of $100,091.38. The amount of $29,193.09 was derived by subtracting the $60,806.91 deficiency judgment from the $90,000 unpaid principal. The Revenue Service countered, in turn, that the taxpayers had a loss of only $10,091.38, derived by subtracting the $90,000 unpaid principal from the $100,091.38 basis of the taxpayers.

The Court rejected both approaches. Noting that this was the first time that a court had confronted this issue directly, the Court found that the "key to the resolution of the issue" was "in the recognition that, in this case, there is a clear separation between the foreclosure sale and the unpaid recourse liability for mortgage principal which survives as part of a deficiency judgment." Accordingly, the Court held that the taxpayers had a loss of $27,391.38, determined by subtracting the foreclosure sale price of $72,000 (the "amount realized" under Sec. 1001(a), I.R.C.) from the taxpayers' $100,091.38 basis at that time.

The Court went on to say that nothing in Comm'r v. Tufts, 461 U.S. 300 (1983), rejects the use of the foreclosure sale proceeds, which represents the fair market value of the property at that time, as the amount realized. Although the language of Tufts suggests that the fair market value is irrelevant where the value is less than the amount of the unpaid mortgage principal, the Court stated that such language was directed to the situation where that mortgage obligation was discharged -- a situation not present here.

B. Berg's Estate v. Comm'r, 61 TCM 2949 (1991). The taxpayer included on the estate tax return shares of stock in a closely held real estate holding company. The Court stated that the valuation of stock in a closely held corporation for estate tax purposes must take into account all relevant facts and circumstances of the particular corporation at issue. The Court found that the proper valuation of such interests may include both minority and lack of marketability discounts. A minority discount is recognized because the holder of a minority interest lacks control over corporate policy, cannot direct the payment of dividends, and cannot compel the liquidation of corporate assets. A lack of marketability discount reflects the fact that there is no ready market for shares in a closely held corporation.

C. Callahan v. Comm'r, 98 T.C. 276 (1992). The taxpayers were limited partners in JEC Options, an Illinois limited partnership. They were required, if called upon by the general
partners, to pay three times the amount of their cash contributions. However, the limited partners had the discretion, by notice in writing, to opt out of the overcall provision. The taxpayers argued, under *Pritchett v. Comm'r*, 827 F.2d 644 (CA9 1987), that they were at risk for three times their capital contributions. The I.R.S. answered that the limited partners were not at risk for amounts in excess of their initial cash contributions because the obligation to make additional contributions under the overcall provision was contingent and illusory. The Court agreed with the Service.

D. *Campbell v. Comm'r*, 943 F.2d 815 (CA8 1991), rev'g 59 TCM 236 (1990). The taxpayer received "special limited partner" interests in 3 separate limited partnerships in which its corporate employer (or one of its affiliates) was the general partner and investors were Class A limited partners. Based on projections when received, cash flow was unlikely for a number of years, but tax losses were allocated to taxpayer right away in each partnership. The taxpayer argued, first, that he had received his partnership interest for services to be rendered to the partnerships, and so, under Sec. 721, had no income; second, that the partnership interests, if property, were so restricted that they were not "transferred" to the taxpayer under Sec. 83, or, if transferred, were subject to substantial risk of forfeiture, and so could not be taxable on receipt; and, third, even if the partnership interests were transferred and not subject to a substantial risk of forfeiture, the value of the interests was so speculative that they were worth, at most, $1,000 each. The Tax Court, reaffirming the viability of *Diamond v. Comm'r*, 56 T.C. 530 (1971), aff'd 492 F.2d 286 (CA7 1974), found that the taxpayer recognized income on the receipt of the partnership interests, and then determined the value of each (taking into account tax losses, projected cash flow and projected residuals). The Circuit Court reversed because, first, the partnership interests received by Campbell were (unlike those received by Diamond) not transferable and not likely to provide immediate returns and, second, such partnership interests were, in reality, only profits interests which had only speculative, if any, value. The bottom line to the Circuit Court was that the partnership interests had no fair market value when received by Campbell and so should not have been included in his income on receipt.

E. *Central States, Southeast and Southwest Pension Fund v. Personnel, Inc.*, ___ F.2d ___, 1992 WL 201108 (CA7 1992). The Fund brought an action against Personnel, Inc. and Eugene Perrelle, its sole owner and president, to collect withdrawal liability of $283,165 owed by Personnel. Under the Multiemployer Pension Plan Amendment Act, an employer which withdraws from a multiemployer pension plan is liable for its pro rata share of the plan's unfunded vested liability. Personnel leased truck
drivers to other firms. Under a collective bargaining agreement, Personnel was required to make contributions to the Fund.

While president of Personnel, Perrelle invested portions of his savings in real estate. While most of the investments were unrelated to Personnel, from 1980 to 1985 Personnel's offices were in a building owned by Perrelle, who received rent from Personnel.

The Fund claimed that Perrelle's real estate activities constituted a trade or business, because under §1301(b)(1) of the Act, each trade or business under common control is jointly and severally liable for the withdrawal of another such business. The Court, reversing the District Court, found that Perrelle's "real estate activities rose to the level of a trade or business because they were continuous and regular and designed to produce income." This was, in the Court's view, attributable to the facts that "Perrelle's real estate activities were quite substantial and were designed to produce income. * * * Even though Perrelle's leasing activity did not produce a net gain after deductions for depreciation, mortgage and other expenses, he received constant benefits from his investment. * * * Perrelle's investments in real estate were more than personal investments, such as holding shares of stock or bonds in publicly traded corporations."

F. Citron v. Comm'r, 97 T.C. 200 (1991). In 1980, the taxpayer borrowed $60,000 and, with three other partners, invested in a limited partnership to produce a motion picture. The general partner of the partnership was a corporation. The motion picture was made using the capital contributions of the partners, and no debt was incurred. After the film was completed, the negative was taken by the executive producer, who, as a result of controversy, refused to return it. The partnership was then dissolved in 1981. The taxpayer reported an ordinary loss of $60,000 on his return for the year of the partnership dissolution, on the theory of loss from theft, embezzlement or abandonment. The Service disallowed the ordinary loss and argued that any loss was from a sale or exchange, and thus a capital loss. The Court held that, because of the genuine dispute between the executive producer and the partnership, there could not be a theft or embezzlement. However, the Court held that the taxpayer had evidenced his intention to abandon the partnership interest (as difficult as that was, because a partnership interest is intangible personal property) by voting to dissolve the partnership and by communicating to the general partner that he no longer had an interest in the partnership or the motion picture. Finally, the Court decided that, because no partnership liabilities existed, so that the taxpayer could not be said to have been directly or constructively paid any consideration for his partnership interest, there was no sale or
exchange that occurred on the abandonment, and so an ordinary loss was allowed.

G. Colorado, Ltd. v. Comm’r, 63 TCM 2435 (1992). The taxpayer was a Texas limited partnership formed to purchase, own, renovate, lease, operate and manage an office building. The taxpayer purchased the building from another entity (FNL) after FNL had expended an extensive amount in connection with the qualified rehabilitation of the building. The taxpayer purchased the building for $9,000,000 under a Texas earnest money contract, and the taxpayer had an actual adjusted basis in the building of $6,920,543.

The taxpayer expended a total of $740,500 in 1983 and 1984 for qualified rehabilitation expenditures. FNL expended $1,978,000 for qualified rehabilitation expenditures before selling the building to the taxpayer, none of which expenditures were claimed for rehabilitation tax credit purposes by FNL. FNL’s adjusted basis in the building before the qualified rehabilitation was begun in $1,814,846.

The issue was whether the taxpayer was entitled to any rehabilitation tax credit, the resolution of which turned on the measurement standards. The taxpayer claimed that the total qualified rehabilitation expenditures (or $2,718,500 ($740,500 plus $1,978,000)) had to be compared to FNL’s (the seller’s) adjusted basis immediately before the commencement of the rehabilitation (or $1,814,846), and so the taxpayer was entitled to the credit. The Service contended that the taxpayer’s basis less the rehabilitation expenditures made by FNL (or $4,942,543 ($6,920,543 less $1,978,000)) had to be compared to the qualified rehabilitation expenditures, including those made by FNL but treated as incurred by the taxpayer (or $2,718,500 ($740,500 plus $1,978,000)), and so the taxpayer was not entitled to the credit. The Court agreed with the Service, holding that the taxpayer was not eligible for the rehabilitation tax credit.

H. Cottage Savings Ass’n. v. Comm’r, 111 S.Ct. 1503 (1991). The taxpayer, a savings and loan association formerly regulated by the FHLBB, held a portfolio of residential real estate mortgages the market value of which had declined as the result of rising interest rates. The taxpayer sought to dispose of these mortgages at a loss in order to generate tax refunds without recording the loss for regulatory accounting purposes. To accomplish this, the taxpayer entered into a concurrent sale transaction with another thrift whereby the taxpayer sold a 90% participation interest in its depreciated portfolio of mortgages to the other thrift and simultaneously purchased from the other thrift a 90% participation interest in another portfolio of residential mortgages. The taxpayer reported the transaction as a loss on its tax return for the year (measured by the difference between the taxpayer’s basis in the mortgages sold and their
then-fair market value), even though the taxpayer was not required to report the loss under then-existing FHLBB accounting rules.

The Supreme Court upheld the taxpayer’s reporting position and sustained the recognition of the loss on its disposition of the mortgage portfolio. In doing so, the Supreme Court concluded that properties differ materially if their respective owners "enjoy legal entitlements that are different in kind or extent". The Court added that the differences between assets need only be minimal in order to satisfy the administrative purposes underlying the realization requirement. The Court found that the participation interests exchanged involved different legal entitlements given that the mortgages contained in each portfolio represented loans made to different borrowers and were secured by different properties.

I. **Depot Investors, Ltd. v. Comm’r**, 63 TCM 2344 (1992). An individual purchased a railroad depot from a city, incurring the obligation either to demolish the depot or remove it by a specified deadline. The depot was subsequently acquired by a corporation, which then transferred it to the taxpayer, a partnership, as a capital contribution. The partnership moved the depot, incurring site preparation, construction and rehabilitation expenses. After modifications were made in the course of relocation and rehabilitation, the structure retained less than 75% of its original vertical exterior walls.

The partnership taxpayer was not entitled to a qualified rehabilitation credit because the structure failed to retain 75% or more of its existing walls in place as external or internal walls in the rehabilitation process, and, thus, was not a qualified rehabilitated building. In making its determination, the Court rejected the taxpayer’s argument that the vertical, triangular and trapezoidal rises of a roof should be included within the term "external wall" for purposes of the 75% calculation.

J. **Echols v. Comm’r**, 935 F.2d 703 (CA5 1991), rev’g 93 T.C. 553 (1989). The taxpayer owned a 37.5 percent interest in a Texas limited partnership, the only asset of which was a tract of unimproved land in Houston. The down payment for the land was made with a loan secured by the partnership and guaranteed personally by the taxpayer and another partner. The remainder of the purchase price was secured by purchase money debt on a nonrecourse basis. The partnership had anticipated that a new highway would be built next to the land, so that the land could be sold at a profit. Everything then changed -- the plans for the highway were dropped due to local opposition, and Houston real estate went into a slump. Thereafter, taxpayer acquired another 37.5 percent for the assumption of the second guarantor partner’s guarantee, and thereafter paid off the recourse debt in
full. When taxpayer found that he could no longer carry his 75 percent of the debt service and real estate taxes, he called a meeting of the partners and told the holder of the other 25 percent that he was foregoing his partnership interest, and that he would give it to anyone who would pick up his share of the nonrecourse debt. From that point, the taxpayer contributed nothing further for real estate taxes or debt service. The Circuit Court, reversing the Tax Court, held that the taxpayer had clearly evidenced his intention to abandon his partnership interest in the tax year claimed, and so was entitled to a loss deduction in that year. As the Circuit Court noted, by the taxpayer telling the other partners that the taxpayer would contribute no more funds to the partnership, the taxpayer was making a "clear and unequivocal indication to [the other partner] and the world" that the taxpayer was "walking from their ownership interest", and the taxpayer "kept that vow, never thereafter to return to acts of ownership toward or contributions to the partnership." The Circuit Court found that the Tax Court had erroneously focused on the partnership’s abandonment of the real estate, rather than only the taxpayer’s abandonment of his partnership interest. The Circuit Court also found that the facts demonstrated, beyond bona fide challenge, that the taxpayer’s interest in the partnership was, in the tax year claimed, both worthless in fact and deemed worthless by taxpayer.

K. Emershaw v. Comm’r, 949 F.2d 841 (6th Cir. 1991). Corporation X made three separate purchases of computer equipment from IBM at an aggregate cost of $2,935,143. The equipment was then leased to several "end users", which took possession of the equipment and used it in their businesses. The purchases were financed by loans which were secured by the equipment as well as subsequent leases of the equipment. After entering into the leases, Corporation X then sold the computer equipment to Corporation Y for a price of $3,030,300. The purchase was made subject to the existing leases and bank liens and was paid for with a down payment of $180,000 and a full recourse installment note for the balance.

The equipment was subsequently sold to Partnership Z, a limited partnership, subject to the bank liens and the rights of existing leaseholders. Part of the purchase price was paid with a "partial recourse secured promissory note" from Partnership Z. Partnership Z then leased the equipment back to Corporation X, subject to the bank liens, the rights of existing lease holders and the security interest of Corporation Y. This leasing transaction included a guaranty of rental obligations to Partnership Z by Corporation P, the parent of Corporation X.

The Tax Court held that the limited partners of Partnership Z were "at risk" for their pro rata share of a partial recourse note issued in connection with the sale-leaseback transaction because the partnership was ultimately
liable on the note. The partners were at risk because the partnership would be liable if the lessor became bankrupt, and such "at risk" status was unaffected by the rent guaranty made by the lessor’s parent corporation.

L. *Frane’s Estate v. Comm’r*, 98 T.C. 341 (1992). In 1982, the decedent organized a corporation, which issued to him 5,000 shares of common stock and 89,845 shares of convertible preferred stock. Shortly thereafter, he sold 1,250 shares of such common stock to each of his four children pursuant to separate, but identical, purchase agreements. Each child executed, pursuant to the purchase agreement, a promissory note, payable in 20 equal installments (together with interest on the unpaid principal balance at 12 percent per annum). Each note provided that, unless sooner paid, "all sums due hereunder, whether principal or interest, shall be deemed cancelled and extinguished as though paid upon the death of Robert E. Frane."

Payments on the notes were made in 1983 and 1984. Decedent died in July 1984, leaving a substantial unpaid principal balance on each note. The estate did not report any gain attributable to the promissory notes held by the decedent at his death.

The Court, noting that under the express terms of the notes the children’s installment obligations to pay decedent were cancelled on the decedent’s death, found that "Section 453B(f) explicitly provides that the cancellation of an installment obligation shall be treated as a taxable disposition of such obligation." The Court further found that, as a result, "each installment obligation is treated as if were disposed of in a transaction other than a sale or exchange by decedent. Sec. 453B(f)(1). Further, because the obligor (each of decedent’s children) and the obligee (decedent) are related, gain was recognized equal in amount to the excess of the face amount of the obligations over basis ‘at the time of’ the transaction -- the date of decedent’s death. Sec. 453B(a)(2), (f)(2). The face amount of each installment obligation is equal to the remaining unpaid principal amount which was cancelled."

M. *Henkind v. Comm’r*, 64 TCM 807 (1992). The taxpayers were limited partners in an automobile leasing limited partnership. Before entering the partnership, the taxpayers carefully investigated the profit potential of car leasing. In addition, projections of profits were made on the basis of reasonable assumptions. Moreover, the business was operated in a businesslike manner on a full-time basis, and the general partner had extensive, long-time experience in auto leasing. At the time the partners entered the activity, economic conditions favored the leasing industry.
The Court found that, for purposes of Sec. 183, I.R.C., the taxpayers established that the auto leasing activity was carried on by the partnership with the actual and honest objective of making a profit.

Furthermore, the Court found that the underlying partnership debts to be paid through additional capital contributions which could be called by the general partner under the partnership agreement were loans negotiated by the partnership at arm's length with unrelated financial institutions. (This distinguished the situation in Pritchett v. Comm'r, 85 T.C. 580 (1985), rev'd and remanded 827 F.2d 644 (CA9 1987).) The general partner had every incentive to make the calls for additional capital contributions because the majority shareholder of the general partner was personally the guarantor of the bank loans, and the limited partners could not elect out of the overcall provision or unilaterally reduce their obligations. Finally, the Court held that the obligations to make additional capital contributions were definite and fixed, and not subject to any stop-loss protection. Accordingly, the Court concluded that the taxpayers were at risk under Sec. 465(b)(3), I.R.C., and entitled to deduct the losses claimed.

N. HGA Cinema Trust v. Comm'r, 950 F.2d 1357 (CA7 1991). A trust held a 5.56% interest in the profits and losses of a limited partnership from 1978 through 1981. Corporations X and Y purchased certain computer equipment from users and then leased the equipment back to the users. To finance the purchase, the corporations obtained nonrecourse loans secured by liens on the equipment and an assignment of rental payments. In 1978, X and Y entered into several agreements with Corporations A and B involving the sale and leaseback of certain computer equipment. On the same date, A and B sold this equipment to Corporation Z, which assumed all rights and obligations of A and B under the leaseback agreements with X and Y.

The Service ruled that a limited partner was liable for deficiencies because long-term notes held by the partnership did not represent a valid debt for which the partnership was "at risk". A genuine debt did not exist because the partnership had no obligation to pay on the notes unless the lessee paid the rent. Thus, the partnership could defer payment on the notes to the extent that it did not receive rentals and, when the lease ended, the partnership could offset the notes with the deferred amounts.

O. Holywell Corporation v. Smith, 112 S.Ct. 1021 (1992). The debtors, four corporate entities and an individual, filed Chapter 11 bankruptcy petitions. The creditors approved a reorganization plan which failed to provide for the filing of tax returns or the payment of any taxes due. The Supreme Court, reversing the Eleventh Circuit in United States v. Smith, 911
F.2d 1539 (CA 11 1990), held that a trustee in a Chapter 11 bankruptcy proceeding is required to file income tax returns that the debtors would have filed had the property of the estate not been assigned to the trustee.

With respect to the corporate debtors, the Court held that the trustee is an "assignee" of "all or substantially all" of the property of the corporation within the meaning of Sec. 6012(b)(3), I.R.C. and is therefore required to file.

With respect to the individual debtor, the Court ruled that the trustee is required by Sec. 6012(b)(4), I.R.C. to file a return because he is a fiduciary of a trust. The Court applied the trust characterization because the plan was described as a trust and was created for the express purpose of liquidating the debtor's estate and distributing it to creditors and, thus, clearly fit within the description of a liquidating trust. The Court rejected arguments that the individual debtor must pay the trust's taxes under the grantor trust rules and that the trustee lacked sufficient discretion to be a fiduciary.

The trustee argued that there is no obligation to file a return in a case in which the plan does not require the payment of taxes by the trustee. The Court observed that, although Section 1141(a) of the Bankruptcy Code states that the provisions of a confirmed plan bind any creditor, that provision does not preclude the United States from seeking the payment of any taxes. Furthermore, although Section 1141(a) binds creditors with respect to pre-confirmation claims, the plan does not bind them with respect to post-confirmation claims. The filing and tax payment obligations in question here were obligations arising after confirmation of the plan and appointment of the trustee.

P. INDOPCO, Inc. v. Comm'r, 112 S.Ct. 1039, 92-2 USTC ¶50,113 (1992). In 1977, National Starch and Chemical Corp. retained lawyers and investment bankers to assist in evaluating an offer by Unilever to acquire all of the National Starch stock. National Starch paid more than $2,800,000 in fees and expenses related to the acquisition, which was ultimately in fact completed.

National Starch deducted the expenses as ordinary and necessary business expenses under Sec. 162, I.R.C. In doing so, the taxpayer relied on Comm'r v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971), interpreting that case as requiring capitalization only if the payment in question served to create or enhance a separate and distinct asset. The Court rejected such interpretation out of hand.

The Court then placed its focus on two considerations. First, whether the expenditures generated a future benefit beyond the year in which they were incurred. Second, whether the
purpose of such expenditures was to change the corporate structure or improve operations in a way that would produce future benefits. The Court, asserting that the "mere presence of an incidental future benefit -- 'some future aspect' -- may not warrant capitalization", found that this transaction produced "significant" future benefits for National Starch. Accordingly, the Court held that the expenditures were not deductible, and had to be capitalized.

Q. Jacobson v. Comm'r, 96 T.C. 577 (1991). Taxpayers owned 100% of partnership X. Partnership X and individual A formed partnership Y in which they held respective ownership interests of 25% and 75%. Partnership X transferred real property to partnership Y and A transferred to partnership Y a cash amount equal to 75% of the value of the property. The cash was immediately transferred to partnership X. Taxpayers reported the transaction as a Sec. 721 contribution of property to partnership Y, followed by a Sec. 731 distribution to taxpayers from partnership Y. The Court held that the transaction was not subject to the treatment accorded by Secs. 721 and 731. Instead, the transaction must be treated as a taxable sale of 75% of the real property to A, the cash contributor.

R. In re Kreidle, 91-2 USTC ¶50,371 (Bankr. D. Colo. 1991). The taxpayer was a 50 percent partner in a general partnership. He was also an officer and director of several related corporations, for which he guaranteed a substantial amount of debt. Between the partnership debt and his guarantees, taxpayer was personally liable for over $8,000,000. Taxpayer went into Chapter 11. Taxpayer had a $2,000,000 basis in the partnership, which became worthless by virtue of the filing of Chapter 11. The Service claimed that the loss was a capital loss, but the Bankruptcy Court held that the loss was an ordinary loss. The Court noted that (1) there was no actual distribution or transfer of property out of the partnership to the taxpayer, and the taxpayer did not receive anything when it became worthless; and (2) there was no deemed distribution at that time under Sec. 752, I.R.C. because there was no discharge of liabilities, inasmuch as taxpayer remained personally liable on the partnership's debts. The Court noted that the Service had itself allowed an ordinary loss deduction in a similar situation in Rev. Rul. 70-355, 1970-2 C.B. 51, which had never been overruled or modified (even though in Rev. Rul. 76-189, 1976-1 C.B. 181, the Service had reached a contrary result on similar facts). The Court also cited Tejon Ranch Co. and Subsidiaries v. Comm'r, 49 TCM 1357 (1985); Zeeman v. United States, 275 F.Supp. 235 (S.D. N.Y. 1967); and Gannon v. Comm'r, 16 T.C. 1134 (1951), in all of which ordinary losses were allowed on the worthlessness of investments in partnerships.
S. In re A.J. Lane & Co., Inc., 133 B.R. 264 (Bankr. D. Mass. 1991). The trustee of a bankruptcy estate requested authority from the Bankruptcy Court to abandon an apartment building back to the bankrupt. Under 11 U.S.C. §554, the trustee of a bankruptcy estate may abandon property of the estate if the property is either "burdensome to the estate" or "of inconsequential value and benefit to the estate". The bankrupt objected, first, because, it claimed, the abandonment did not fit into either statutory definition and, second, because, it asserted, the abandonment "would shift foreclosure tax consequences from the bankruptcy estates to the Debtor and would destroy the Debtor’s opportunity for a fresh start."

The Court agreed that the property was "unquestionably encumbered beyond [its] value". However, because a "cram-down" plan could be utilized, the Court noted that the secured claims could be effectively reduced to the value of their mortgage interests. Furthermore, abandonment was, in the Court’s view, unnecessary because the property could be removed from the bankruptcy estate just as easily by not objecting to the then-pending foreclosure sale of the property.

Importantly, the Court found that abandonment could not be allowed because of the Federal income tax consequences, buying the arguments made by the bankrupt. The bankrupt argued that the bankrupt estate would in any event be taxed under one or more of three theories. First, abandonment would be a taxable event in any event because it constitutes a sale or exchange of the property. Second, under Comm’r v. Court Holding Co., 324 U.S. 331 (1945), the impending foreclosure sale could not be transformed by the bankrupt through a prior tax-motivated transfer. Finally, abandonment would not escape taxation under Sec. 1398(f)(2), I.R.C., as a transfer at the "termination of the estate".

The Court was, at the bottom line, most concerned that the "tax burden would inhibit the Debtor’s fresh start. Section 554 should be interpreted in a fashion which promotes the Debtor’s fresh start where, as here, there is no countervailing consideration which overrides the fresh start policy."

T. Mark IV Pictures, Inc. v. Comm’r, 969 F.2d 669 (CA8 1992), aff’g 60 TCM 1171 (1990). The taxpayers acquired general partner interests in several limited partnerships formed for the purpose of producing, distributing and exhibiting motion pictures. The taxpayers developed or otherwise acquired rights to the original story ideas and prepared scripts before forming the limited partnerships and contributing such items to such partnerships. The general partners performed ongoing services for the partnerships, including raising funds, producing the movies and releasing and distributing the films. The general partners were paid for producing the movies, and were to be paid.
out of receipts for their release and distribution efforts. These payments were based on what the general partners believed were reasonable charges for the services.

The Service determined that the general partner interests were capital interests in the partnerships representing additional compensation for services rendered to the partnerships by the general partners. The Court, affirming the Tax Court, concurred.

The Court noted that the partnership interests received by the general partners were entitled to 50 percent of the profits and losses and the liquidating proceeds of the partnerships. However, the Court interpreted state law to mean that, nonetheless, the limited partners were entitled to a return of their capital contributions prior to the time that the general partners would receive any liquidating proceeds.

The Court, affirming the Tax Court, held that, notwithstanding the contribution of such film rights, the general partner interests were received entirely for services because the general partners could not prove that they were compensated fully for all services they performed for the partnerships. The Court further held that, even though there might be no partnership liquidating proceeds remaining to be distributed to the general partners after creditors and the limited partners (to the extent of their capital contributions) were fully satisfied, nevertheless, because the general partners had the right to receive a share of the partnership assets, they were deemed to receive capital interests in the partnerships on their acquisition of the general partner interests.

U. McLennan v. United States, 24 Cl.Ct. 102 (Cl. Ct. 1991). Taxpayer made a charitable contribution of a scenic easement to a non-profit corporation. The corporation was dedicated to the cause of nature preservation and conservation, and the easement solicited from taxpayer restricted the future use of the land in accordance with the objectives of the donee. It was asserted that the taxpayer participated in the scenic easement program to maintain property values and to receive a tax deduction and, as such, lacked the required donative intent and exclusive conservation purpose at the time of the transfer. Further support for this position was found in the fact that taxpayer sought reconveyance of the easement following disallowance of a significant portion of the charitable contribution.

After consideration of the circumstances involved, the Court permitted the taxpayer to claim the charitable deduction for the value of the scenic easement contribution, finding satisfaction of both the donative intent and conservation purpose requirements. The Court recognized that, although a taxpayer
must not expect a substantial benefit as quid pro quo for a charitable contribution, the charitable nature of a contribution is not vitiates by the receipt of a benefit incidental to a greater public benefit.

V. Moore v. Comm’r, 62 TCM 1128 (1991). Taxpayers made gifts of certain partnership interests, with each interest transferred to each individual or entity representing less than a one percent interest in the partnership. The amounts reported by the taxpayers for gift tax purposes did not reflect a pro rata share of the net asset value of the partnership. Rather, the reported amount reflected a 40% discount from the pro rata share of the net asset value, reflecting a lack of control and a lack of liquidity associated with the interests. After consideration of expert testimony, the Court concluded that, in valuation of the partnership interests for gift tax purposes, it was proper that the calculation incorporate minority and lack of marketability discounts.

The determination of the amount of such a discount requires a consideration of many factors. In establishing an appropriate discount for lack of control associated with an interest, taxpayers’ expert considered the following factors: (1) inability to select managers; (2) lack of control over management policies; (3) lack of control of salaries of managers; and (4) inability to control asset acquisitions or dispositions. In establishing an appropriate discount for lack of liquidity, the following factors were considered: (1) absence of an established market; (2) inability to force liquidation; (3) no expectation of consent to liquidation of assets; (4) consent requirement for assignment; (5) consent requirement for withdrawal; (6) first refusal option to remaining partners upon withdrawal, combined with a market glut for such properties, indicated that any exercise of such option would be at a discount; and (7) withdrawal without consent would not discharge withdrawing partner from additional liabilities incurred by the partnership.

W. Nalle v. Comm’r, 99 T.C. _____, No. 9 (1992). The taxpayer was a partner in a joint venture which purchased two historic houses and moved them to a historic office subdivision, where they were rehabilitated. In addition, the taxpayer personally purchased six buildings, which were transported to the same historic office subdivision, where they were rehabilitated. The Court held that the taxpayer was not entitled to any rehabilitation tax credit because, under Reg. §1.48-12(b)(5), the location of each of the buildings was changed prior to rehabilitation. The Court noted that "Congress envisioned that the rehabilitation tax credit would provide a financial incentive for existing businesses to improve their facilities and plants in older locations rather than to abandon those facilities for another locale. Similarly, the credit would provide an incentive for new businesses to locate in such areas. * * * As we see it,
the removal of a building from a declining area of an inner city or community will provide little or no economic benefit to that area."

X. United States v. Nordic Village, Inc., 112 S.Ct 1011 (1992). In March 1984, Nordic Village, Inc. filed for reorganization under Chapter 11. Later in 1984, Mr. Lah, an officer and shareholder, drew a $26,000 check on the bankrupt’s account and used $20,000 of such amount to obtain a cashier’s check payable to the Service, which he used for his personal tax liability. In December 1984, the bankruptcy trustee sued the Service for the recovery of the money. The Service lost at the Bankruptcy Court, District Court and Court of Appeals levels, although it raised sovereign immunity, for the first time, at the Sixth Circuit level. The Supreme Court reversed, based on sovereign immunity.

This decision may well limit the bankrupt trustee’s power to recover funds from the Federal Government, except tax refunds under 11 U.S.C. §505(a)(2) and perhaps in counterclaim situations. See also United States v. Whiting Pools, Inc., 462 U.S. 198 (1983), where the Service was ordered (under 11 U.S.C. §542(a)) to return property it had seized before the debtor’s petition was filed because the property was necessary to the debtor’s reorganization.

Y. In re Olson, 930 F.2d 6 (CA8 1991). The taxpayer was a bankruptcy estate. The debtors in the underlying Chapter 7 bankruptcy case owned two tracts of land which were subject to a bank mortgage. The trustee in bankruptcy abandoned the real estate during the pendency of the case, and such real estate was eventually sold at a gain in foreclosure proceedings by the bank which held a mortgage on the property. The tax return which was filed on behalf of the bankruptcy estate reported gain realized from the sale of the land as a liability of the estate for the tax. The gain was treated as realized by the bankruptcy estate upon the abandonment of the land by the trustee. The Court held that (1) there was no recognized gain or loss to the bankruptcy estate upon the abandonment of the property, and (2) the gain which was realized upon the sale of the property was income of the debtor, not the bankruptcy estate, because after the property was abandoned by the trustee it became property of the debtor.

Z. Regents Park Partners v. Comm’r, 63 TCM 3131 (1992). The taxpayer, after months of negotiation, obtained two apartment buildings from HUD. The Service made a number of arguments, including that (i) the property acquisition was a sham transaction and (ii) because the nonrecourse debt, to which the property was subject at the time of the acquisition, unreasonably exceeded the fair market value of the property, such debt must be excluded in full in determining the partnership’s basis in the property.
Because of the nature of the negotiations with HUD, with which the taxpayer clearly was not related, as well as the structure of the financing and the degree of adherence to contractual terms, the Court was satisfied that the terms of the deal were the result of arm's-length negotiations. Accordingly, the Court was "persuaded that the transaction had economic substance. Consequently, the transaction was not a sham."

Furthermore, the Court found that the debt exceeded the fair market value of the property. The Service argued that this meant that the debt should therefore be fully excluded from basis. However, the Court found that the taxpayer still "had a legitimate economic interest to continue to make payments on the debt, and that it was unlikely to abandon or walk away from the transaction." Accordingly, the Court held that "under the particular circumstances of this case, which involves, inter alia, the acquisition of property subject to nonrecourse indebtedness that exceeds its fair market value, the partnership is entitled to a basis in the amount of the property's fair market value; and the indebtedness, to the extent that it exceeds fair market value, is treated as a contingent liability, and not as an addition to basis." The Court thus followed Pleasant Summit Land Corp. v. Comm'r, 863 F.2d 263 (CA3 1988), rather than Estate of Franklin v. Comm'r, 544 F.2d 1045 (CA9 1976), aff'g on different grounds 64 T.C. 752 (1975). See also Sec. 752(c), I.R.C.

AA. Soliman v. Comm'r, 935 F.2d 52 (CA4 1991), cert. granted. The Circuit Court affirmed the Tax Court's formulation of a new "facts and circumstances" test in holding that the taxpayer, an anesthesiologist who worked at three hospitals, but was not provided an office at any of them, was entitled to a home office deduction under Sec. 280A (c)(1), I.R.C. The "facts and circumstances" test replaces the former "focal point" test, which looked to the place where the goods and services were provided to customers and revenues were generated.

The "facts and circumstances" test provides that, where management or administrative activities are essential to the taxpayer's trade or business, and the only available office space is in the taxpayer's home, the "home office" can be the taxpayer's principal place of business where (1) the office in the home is essential to the taxpayer's business; (2) the taxpayer spends a substantial amount of time there; and (3) there is no other location available for performance of the office functions of the business.

BB. West v. Comm'r, 61 TCM 1694 (1991). In accordance with the delinquency charge provisions of their mortgage loan, taxpayers paid approximately $1,000 for such charges during the tax year and attempted to deduct such payments as interest. In Rev. Rul. 74-187, 1974-1 C.B. 48, the Service held that a late
penalty charge assessed by a public utility is deductible as interest. The Tax Court declined to follow Rev. Rul. 74-187, observing that the late charge in this case was assessed primarily to recoup costs attendant in the bank's attempt to collect the delinquent loan. In the cited Revenue Ruling, the Service assumed that the late payment charge was for the use or forbearance of money. The Court held that late payment charges on a mortgage were not deductible as a mortgage interest expense.