Section 108.—Income From Discharge of Indebtedness

26 CFR 1.108–1(a)(1): Income from discharge of indebtedness.

Do allocations of cancellation of indebtedness income to an insolvent partner lack substantiality under § 1.704–1(b)(2)(iii) of the Income Tax Regulations when the partners amend the partnership agreement to create offsetting special allocations of particular items after the events giving rise to the items have occurred? See Rev. Rul. 99–43, on this page.

Section 704.—Partner's Distributive Share

26 CFR 1.704–1: Determination of partner's distributive share.

26 CFR 1.704–2: Allocations attributable to nonrecourse liabilities.
(Also Part 1, section 108; 1.108–1(a)(1).)

Partnership allocations; cancellation of nonrecourse indebtedness. This ruling provides guidance on the substantiality of special allocations made by amendments to a partnership agreement after the events giving rise to the specially allocated items have occurred.

Rev. Rul. 99–43

ISSUE

Do partnership allocations lack substantiality under § 1.704–1(b)(2)(iii) of the Income Tax Regulations when the partners amend the partnership agreement to create offsetting special allocations of particular items after the events giving rise to the items have occurred?

FACTS

A and *B*, both individuals, formed a general partnership, *PRS*. *A* and *B* each contributed $1,000 and also agreed that each would be allocated a 50-percent share of all partnership items. The partnership agreement provides that, upon the contribution of additional capital by either partner, *PRS* must revalue the partnership's property and adjust the partners' capital accounts under § 1.704–1(b)(2)(iv)(*f*).

PRS borrowed $8,000 from a bank and used the borrowed and contributed funds to purchase nondepreciable property for $10,000. The loan was nonrecourse to *A* and *B* and was secured only by the property. No principal payments were due for 6 years, and interest was payable semi-annually at a market rate.

After one year, the fair market value of the property fell from $10,000 to $6,000, but the principal amount of the loan remained $8,000. As part of a workout arrangement among the bank, *PRS*, *A*, and *B*, the bank reduced the principal amount of the loan by $2,000, and *A* contributed an additional $500 to *PRS*. *A*'s capital account was credited with the $500, which *PRS* used to pay currently deductible expenses incurred in connection with the workout. All $500 of the currently deductible workout expenses were allocated to *A*. *B* made no additional contribution of capital. At the time of the workout, *B* was insolvent within the meaning of § 108(a) of the Internal Revenue Code. *A* and *B* agreed that, after the workout, *A* would have a 60-percent interest and *B* would have a 40-percent interest in the profits and losses of *PRS*.

As a result of the property's decline in value and the workout, *PRS* had two items to allocate between *A* and *B*. First, the agreement to cancel $2,000 of the loan resulted in $2,000 of cancellation of indebtedness income (COD income). Second, *A*'s contribution of $500 to *PRS* was an event that required *PRS*, under the partnership agreement, to revalue partnership property and adjust *A*'s and *B*'s capital accounts. Because of the decline in value of the property, the revaluation resulted in a $4,000 economic loss that must be allocated between *A*'s and *B*'s capital accounts.

Under the terms of the original partnership agreement, *PRS* would have allocated these items equally between *A* and *B*. *A* and *B*, however, amend the partnership agreement (in a timely manner) to make two special allocations. First, *PRS* specially allocates the entire $2,000 of COD income to *B*, an insolvent partner. Second, *PRS* specially allocates the book loss from the revaluation $1,000 to *A* and $3,000 to *B*.

While *A* receives a $1,000 allocation of book loss and *B* receives a $3,000 allocation of book loss, neither of these allocations results in a tax loss to either partner. Rather, the allocations result only in adjustments to *A*'s and *B*'s capital accounts. Thus, the cumulative effect of the special allocations is to reduce each partner's capital account to zero immediately following the allocations despite the fact that *B* is allocated $2,000 of income for tax purposes.

LAW

Section 61(a)(12) provides that gross income includes income from the discharge of indebtedness.

Rev. Rul. 91–31, 1991–1 C.B. 19, holds that a taxpayer realizes COD income when a creditor (who was not the seller of the underlying property) reduces the principal amount of an under-secured nonrecourse debt.

Under § 704(b) and the regulations thereunder, allocations of a partnership's items of income, gain, loss, deduction, or credit provided for in the partnership agreement will be respected if the allocations have substantial economic effect. Allocations that fail to have substantial economic effect will be reallocated according to the partners' interests in the partnership (as defined in § 1.704–1(b)(3)).

Section 1.704–1(b)(2)(iv)(*f*) provides that a partnership may, upon the occurrence of certain events (including the contribution of money to the partnership by a new or existing partner), increase or decrease the partners' capital accounts to reflect a revaluation of the partnership property.

Section 1.704–1(b)(2)(iv)(*g*) provides that, to the extent a partnership's property is reflected on the books of the partnership at a book value that differs from the adjusted tax basis, the substantial economic effect requirements apply to the allocations of book items. Section 704(c) and § 1.704–1(b)(4)(i) govern the partners' distributive shares of tax items.

Section 1.704–1(b)(2)(i) provides that the determination of whether an allocation of income, gain, loss, or deduction (or item thereof) to a partner has substantial economic effect involves a two-part analysis that is made at the end of the partnership year to which the allocation relates. In order for an allocation to have substantial economic effect, the allocation must have both economic effect (within the meaning of § 1.704–1(b)(2)(ii)) and be substantial (within the meaning of § 1.704–1(b)(2)(iii)).

Section 1.704-1(b)(2)(iii)(*a*) provides that the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will substantially affect the dollar amounts to be received by the partners from the partnership independent of the tax consequences. However, the economic effect of an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to the consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to the consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with the partner's tax attributes that are unrelated to the partnership will be taken into account.

Section 1.704–1(b)(2)(iii)(*b*) provides that the economic effect of an allocation (or allocations) in a partnership taxable year is not substantial if the allocations result in shifting tax consequences. Shifting tax consequences result when, at the time the allocation (or allocations) becomes part of the partnership agreement, there is a strong likelihood that (1) the net increases and decreases that will be recorded in the partners' respective capital accounts for the taxable year will not differ substantially from the net increases and decreases that would be recorded in the partners' respective capital accounts for the year if the allocations were not contained in the partnership agreement, and (2) the total tax liability of the partners (for their respective tax years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement.

Section 1.704–1(b)(2)(iii)(*c*) provides that the economic effect of an allocation (or allocations) in a partnership taxable year is not substantial if the allocations are transitory. Allocations are considered transitory if a partnership agreement provides for the possibility that one or more allocations (the "original allocation(s)") will be largely offset by other allocations (the "offsetting allocation(s)"), and, at the time the allocations become part of the partnership agreement, there is a strong likelihood that (1) the net increases and decreases that will be recorded in the partners' capital accounts for the taxable years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such years if the original and offsetting allocation(s) were not contained in the partnership agreement, and (2) the total tax liability of the partners (for their respective tax years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement.

Section 761(c) provides that a partnership agreement includes any modifications made prior to, or at, the time prescribed for filing a partnership return (not including extensions) which are agreed to by all partners, or which are adopted in such other manner as may be provided by the partnership agreement.

ANALYSIS

PRS is free to allocate partnership items between *A* and *B* in accordance with the provisions of the partnership agreement if the allocations have substantial economic effect under § 1.704–1(b)(2). To the extent that the minimum gain chargeback rules do not apply,[1] COD income may be allocated in accordance with the rules under § 1.704–1(b)(2). This is true notwithstanding that the COD income arises in connection with the cancellation of a nonrecourse debt.

The economic effect of an allocation is not substantial if, at the time that the allocation becomes part of the partnership agreement, the allocation fails each of two tests. The allocation fails the first test if the after-tax consequences of at least one partner may, in present value terms, be enhanced compared to the consequences if the allocation (or allocations) were not contained in the partnership agreement. The allocation fails the second test if there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.

A and *B* amended the *PRS* partnership agreement to provide for an allocation of the entire $2,000 of the COD income to *B*. *B*, an insolvent taxpayer, is eligible to exclude the income under § 108, so it is unlikely that the $2,000 of COD income would increase *B*'s immediate tax liability. Without the special allocation, *A*, who is not insolvent or otherwise entitled to exclude the COD income under § 108, would pay tax immediately on the $1,000 of COD income allocated under the general ratio for sharing income. *A* and *B* also amended the *PRS* partnership agreement to provide for the special allocation of the book loss resulting from the revaluation. Because the two special allocations offset each other, *B* will not realize any economic benefit from the $2,000 income allocation, even if the property subsequently appreciates in value.

The economics of *PRS* are unaffected by the paired special allocations. After the capital accounts of *A* and *B* are adjusted to reflect the special allocations, *A* and *B* each have a capital account of zero. Economically, the situation of both partners is identical to what it would have been had the special allocations not occurred. In addition, a strong likelihood exists that the total tax liability of *A* and *B* will be less than if *PRS* had allocated 50 percent of the $2,000 of COD income and 50 percent of the $4,000 book loss to each partner. Therefore, the special allocations of COD income and book loss are shifting allocations under § 1.704–1(b)(2)(iii)(*b*) and lack substantiality. (Alternatively, the

[1] Under certain circumstances, the COD income would be allocated between the partners in accordance with their shares of partnership minimum gain because the cancellation of the nonrecourse debt would result in a decrease in partnership minimum gain. *See* § 1.704–2(d). However, in this situation, there is no minimum gain because the principal amount of the debt never exceeded the property's book value. Therefore, the minimum gain chargeback requirement does not govern the manner in which the COD income is allocated between A and B, and PRS's special allocation of COD income must satisfy the substantial economic effect standard. *See* Rev. Rul. 92–97, 1992–2 C.B. 124.

allocations could be transitory allocations under § 1.704–1(b)(2)(iii)(*c*) if the allocations occur during different partnership taxable years).

This conclusion is not altered by the "value equals basis" rule that applies in determining the substantiality of an allocation. See § 1.704–1(b)(2)(iii)(*c*)(*2*). Under that rule, the adjusted tax basis (or, if different, the book value) of partnership property will be presumed to be the fair market value of the property. This presumption is appropriate in most cases because, under § 1.704–1(b)(2)(iv), property generally will be reflected on the books of the partnership at its fair market value when acquired. Thus, an allocation of gain or loss from the disposition of the property will reflect subsequent changes in the value of the property that generally cannot be predicted.

The substantiality of an allocation, however, is analyzed "at the time the allocation becomes part of the partnership agreement," not the time at which the allocation is first effective. See § 1.704–1(b)(2)(iii)(*a*). In the situation described above, the provisions of the *PRS* partnership agreement governing the allocation of gain or loss from the disposition of property are changed at a time that is after the property has been revalued on the books of the partnership, but are effective for a period that begins prior to the revaluation. See § 1.704–1(b)(2)(iv)(*f*).

Under these facts, the presumption that value equals basis does not apply to validate the allocations. Instead, *PRS*'s allocations of gain or loss must be closely scrutinized in determining the appropriate tax consequences. *Cf*. § 1.704–1(b)(4)(vi). In this situation, the special allocations of the $2,000 of COD income and $4,000 of book loss will not be respected and, instead, must be allocated in accordance with the *A*'s and *B*'s interests in the partnership under § 1.704–1(b)(3).

Close scrutiny also would be required if the changes were made at a time when the events giving rise to the allocations had not yet occurred but were likely to occur or if, under the original allocation provisions of a partnership agreement, there was a strong likelihood that a disproportionate amount of COD income earned in the future would be allocated to any partner who is insolvent at the time of the allocation and would be offset by an increased allocation of loss or a reduced allocation of income to such partner or partners.

HOLDING

Partnership special allocations lack substantiality when the partners amend the partnership agreement to specially allocate COD income and book items from a related revaluation after the events creating such items have occurred if the overall economic effect of the special allocations on the partners' capital accounts does not differ substantially from the economic effect of the original allocations in the partnership agreement.

DRAFTING INFORMATION

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Section 832.—Insurance Company Taxable Income

26 CFR 1.832–4: Gross income.

The salvage discount factors are set forth for the 1999 accident year. These factors will be used for computing estimated salvage recoverable for purposes of section 832 of the Code. See Rev. Proc. 99–37, page 517.

Section 846.—Discounted Unpaid Losses Defined

26 CFR 1.846–1: Application of discount factors.

The loss payment patterns and discount factors are set forth for the 1999 accident year. These factors will be used for computing discounted unpaid losses under section 846 of the Code. See Rev. Proc. 99–36, page 509.

The salvage discount factors are set forth for the 1999 accident year. These factors will be used for computing estimated salvage recoverable for purposes of section 832 of the Code. See Rev. Proc. 99–37, page 517.