

Part I

Section 752.- Treatment of Certain Liabilities

26 CFR 1.752-1: Treatment of certain liabilities

(Also §§ 1031; 1.704-2, 1.731-1, 1.1031(b)-1, 1.1031(k)-1.)

Rev. Rul. 2003-56

ISSUE

If a partnership enters into an exchange that qualifies as a deferred like kind exchange under § 1031 of the Internal Revenue Code in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the following taxable year of the partnership, are the liabilities netted for purposes of § 752, and if so, when is any net change in a partner's share of partnership liability taken into account?

FACTS

Situation 1. P is a general partnership with two equal partners that reports on the calendar year. P owns Property 1, which has a fair market value of \$300 \times and is subject to a liability of \$100 \times . P has an adjusted basis of \$80 \times in Property 1. P enters into an agreement for a deferred like kind exchange of properties that qualifies under § 1031(a)(1). Pursuant to the agreement, P transfers Property 1 on October 16, Year 1, subject to the liability. On January 17, Year 2, P receives Property 2, which has a fair market value of \$260 \times , subject to a liability of \$60 \times . Thus, P has a net decrease in liability of \$40 \times .

Situation 2. Situation 2 is the same as Situation 1 except that Property 2 has a fair market value of \$340 \times and is subject to a liability of \$140 \times . Thus, P has a net increase in liability of \$40 \times .

LAW

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by the partner of partnership liabilities, shall be considered as a contribution of money by the partner to the partnership.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of the individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

Section 1031(a)(3) provides that any property received by a taxpayer will be treated as property which is not like kind property if (A) the property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (B) the property is received after the earlier of (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (ii) the due date (including extensions) for the taxpayer's federal income tax return for the taxable year in which the transfer of the relinquished property occurs.

Section 1031(b) provides that if an exchange would be within the provisions of § 1031(a) if it were not for the fact that the property received in exchange consists not only of property permitted by the provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of the money and the fair market value of the other property.

Section 1.1031(b)-1(c) of the Income Tax Regulations provides that consideration in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as "other property or money" for the purposes of § 1031(b). Where, in an exchange described in § 1031(b), each party either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of other property or money, consideration given in the form of an assumption of liabilities (or the receipt of property subject to a liability) is offset against consideration received in the form of an assumption of liability (or transfer subject to a liability).

Example (5) of § 1.1031(k)-1(j)(3), describes the following situation: B has an adjusted basis in real property X of \$40,000. On May 17, 1991, B transfers real property X, which is encumbered by a mortgage of \$30,000 and has a fair market value of \$100,000, to C with C assuming the \$30,000 mortgage on real property X. On July 5, 1991, C transfers real property V, which is encumbered by a \$20,000 mortgage and has a fair market value of \$90,000, to B with B assuming the mortgage. The consideration received by B in the form of the liability assumed by C (\$30,000) is offset by the consideration given by B in the form of the liability assumed by B (\$20,000), and the net amount, \$10,000, is treated as "money or other property." Thus, B recognizes gain under § 1031(b) in the amount of \$10,000.

Rev. Rul. 94-4, 1994-1 C.B. 196, holds that a deemed distribution of money under § 752(b) resulting from a decrease in a partner's share of the liabilities of a partnership is treated as an advance or drawing of money under § 1.731-1(a)(1)(ii) to the extent of the partner's distributive share of income for the partnership taxable year.

An amount treated as an advance or drawing of money is taken into account at the end of the partnership taxable year.

Section 1.704-2(d)(1) provides that the amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year.

ANALYSIS

If a partnership enters into a § 1031 exchange, consideration given in the form of the receipt of the replacement property subject to a liability (replacement liability) is offset against consideration received in the form of the transfer of the relinquished property subject to a liability (relinquished liability) in determining the amount of money or other property for purposes of § 1031(b) (hereinafter referred to simply as “money or other property”) received in the exchange that is used to calculate gain recognized under § 1031(b). Section 1.1031(b)-1(c). If the exchange straddles two taxable years of the partnership, the amount of the relinquished liability that exceeds the amount of the replacement liability is treated as money or other property received in the first taxable year of the partnership, since the excess is attributable to the transfer of the relinquished property subject to the relinquished liability in that year. In addition, any gain resulting from the receipt of money or other property in the first taxable year of the partnership must be recognized and reported in that year.

The liability offsetting rule of § 1.1031(b)-1(c) also is taken into account for purposes of determining the amount of any decrease in a partner’s share of partnership liability under § 752(b), which is treated as a deemed distribution of money to the partner. Accordingly, if a partnership enters into a § 1031 exchange that straddles two taxable years of the partnership, each partner’s share of the relinquished liability is offset with each partner’s share of the replacement liability for purposes of determining any decrease in a partner’s share of partnership liability under § 752(b). Any net decrease is taken into account in the first taxable year of the partnership since it is attributable to the transfer of the relinquished property subject to the relinquished liability in that year.

Any deemed distribution of money to the partners under § 752(b) in the first taxable year of the partnership is treated as an advance or drawing of money to the extent of each partner’s distributive share of partnership income for that year. Rev. Rul. 94-4. For this purpose, any gain recognized by the partnership under § 1031(b) from the net decrease in liability resulting from the exchange is included in the partners’ distributive share of partnership income for the first taxable year of the partnership. An amount treated as an advance or drawing of money is taken into account by the

partners at the end of that year.

In addition, if a partner's share of the replacement liability exceeds the partner's share of the relinquished liability, only the net increase in liability is taken into account for purposes of determining the increase in the partner's share of partnership liability under § 752(a). The net increase is taken into account in the second taxable year of the partnership since it is attributable to the receipt of the replacement property subject to the replacement liability in that year.

Furthermore, if the relinquished liability and the replacement liability are nonrecourse liabilities, then under § 1.704-2(d), the partnership minimum gain on the last day of the first taxable year of the partnership is computed by using the replacement property and the replacement nonrecourse liability.

In Situation 1, P's amount realized is \$300 \times (the fair market value of the replacement property (\$260 \times), increased by the relinquished liability (\$100 \times), and decreased by the replacement liability (\$60 \times)), and P's adjusted basis in the relinquished property is \$80 \times , resulting in a realized gain of \$220 \times . Under § 1031(b), P recognizes gain only to the extent of money or other property received in the exchange. The relinquished liability of \$100 \times is offset by the replacement liability of \$60 \times in determining the amount of money or other property that P is treated as receiving. Therefore, under § 1031(b), P is treated as receiving \$40 \times of money or other property and therefore recognizes a gain of \$40 \times in Year 1. That gain is allocated \$20 \times to each partner of P as part of each partner's distributive share of P's Year 1 income. Furthermore, under § 752(b), each partner is treated as receiving a deemed distribution from the partnership of \$20 \times in Year 1. Under Rev. Rul. 94-4, each partner's § 752(b) deemed distribution of \$20 \times is treated as an advance or drawing of money to the extent of each partner's distributive share of P's income for Year 1.

In Situation 2, P's amount realized is \$300 \times (the fair market value of the replacement property (\$340 \times), increased by the relinquished liability (\$100 \times), and decreased by the replacement liability (\$140 \times)), and P's adjusted basis in the relinquished property is \$80 \times , resulting in a realized gain of \$220 \times . Under § 1031(b), P recognizes gain only to the extent of money or other property received in the exchange. The relinquished liability of \$100 \times is offset by the replacement liability of \$140 \times in determining the amount of money or other property that P is treated as receiving. Therefore, under § 1031(b), P is not treated as having received money or other property. Accordingly, P recognizes no gain in Year 1. Furthermore, under § 752(a), each partner is treated as having made a contribution to the partnership of \$20 \times in Year 2.

HOLDING

If a partnership enters into an exchange that qualifies as a deferred like kind exchange under § 1031 in which property subject to a liability is transferred in one taxable year of the partnership and property subject to a liability is received in the

following taxable year of the partnership, the liabilities are netted for purposes of § 752. Any net decrease in a partner's share of partnership liability is taken into account for purposes of § 752(b) in the first taxable year of the partnership, and any net increase in a partner's share of partnership liability is taken into account for purposes of § 752(a) in the second taxable year of the partnership.

DRAFTING INFORMATION

The principal author of this revenue ruling is Pietro Canestrelli of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For more information regarding this revenue ruling contact Mr. Canestrelli at (202) 622-3060 (not a toll-free call).