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December 24, 1998

LEGEND

PRS =

LLC =

STATE =

a =

b =

c =

d =

e =

f =

D1 =

This responds to your authorized representative's letter, dated December 3, 1998, and prior correspondence, requesting rulings under § 707 of the Internal Revenue Code concerning the proposed contribution of an apartment complex (the "Property") to a partnership.

FACTS AND REPRESENTATIONS

PRS is a STATE limited partnership. PRS currently owns and operates the Property, which has a fair market value of approximately a and is subject to mortgage debt of approximately b. PRS obtained the Property's existing mortgage in 1988. The Property requires c in renovations. PRS's current partners are not interested in contributing or borrowing the funds necessary to renovate the Property and seek instead a stable return on the Property's existing value.

PRS, to raise renovation capital and relieve itself from managing the Property, agreed with LLC to form a new partnership ("PRS2"). Pursuant to a contribution agreement, entered into by PRS and LLC on D1, PRS will contribute the Property, subject to the mortgage, to PRS2 in exchange for a limited partner interest and a guaranteed payment and LLC will contribute capital in exchange for a general partner interest. As the general partner, LLC will engage an affiliate, a professional property manager, to manage the Property.

Following the formation of PRS2, PRS would own no significant assets other than its interest in PRS2. PRS2 will repay the existing mortgage secured by the Property and obtain a replacement loan. The replacement loan will be in an amount between d and e. LLC's cash contribution, plus any of the replacement loan amount not used to repay the existing mortgage, will be used to renovate the Property. The PRS2 partnership agreement obligates LLC to cause PRS2 to spend no less than f on renovations to the Property within two years of PRS2's formation. LLC will not contribute, and PRS2 will not hold, cash or liquid assets beyond the reasonable needs of operating the Property.

Under the partnership agreement, PRS2 will make monthly guaranteed payments to PRS equal to one-twelfth of 6.5 percent of the amount by which PRS's net capital contribution exceeds any distribution to PRS of proceeds from a sale or refinancing of the Property. Ten years after PRS2's formation, the amount of the monthly guaranteed payment will include an additional $10,000. PRS2 will distribute excess operating cash (rental receipts less payments of current expenses and other current obligations of PRS2, including the guaranteed payment to PRS) first to LLC as a preferred return on its capital contribution and then 99 percent to LLC and 1 percent to PRS. Upon a subsequent sale or refinancing of the Property, the proceeds will be distributed first to PRS in an amount equal to its outstanding net capital account, then to LLC in an amount equal to its outstanding net capital account, and finally 99 percent to LLC and 1 percent to PRS.

Neither PRS2 nor LLC will be obligated to sell or refinance the Property at any particular time or price. Moreover, other than obtaining the replacement loan, PRS2 has no intention to refinance, or to incur additional mortgage debt. The proceeds of the

replacement loan and LLC's capital contributions may be distributed to PRS to the extent that PRS2 is otherwise unable to make the guaranteed payments.

LLC has no personal liability or obligation that requires it to contribute or otherwise provide funds to enable PRS2 to make the guaranteed payments. If PRS2 fails to make timely guaranteed payments, PRS's sole remedy is to become the general partner of PRS2 and cause LLC to become the limited partner (without any change to their respective interests in profits, losses, and distributions).

LAW AND ANALYSIS

Section 707(a)(1) provides that if a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

Section 707(a)(2)(B) provides that if (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers when viewed together are properly characterized as a sale or exchange of property, then such transfers shall be treated either as a transaction described in § 707(a)(1) or as a transaction between two or more partners acting other than in their capacity as members of the partnership.

Section 1.707-3(a)(1) of the Income Tax Regulations provides that, except as otherwise provided, if a transfer of property by a partner to a partnership and one or more transfers of money or other consideration by the partnership to that partner are described in § 1.707-3(b)(1), the transfers are treated as a sale of property, in whole or in part, to the partnership.

Section 1.707-3(b)(1) provides that a transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances (i) the transfer of money or other consideration would not have been made but for the transfer of property; and (ii) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

Section 1.707-3(c)(1) provides that, if within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to

be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.

Section 1.707-4(a)(1)(i) provides that a guaranteed payment for capital made to a partner is not treated as part of a sale of property under § 1.707-3(a). The term guaranteed payment for capital means any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of a partner's capital. However, one or more payments are not made for the use of a partner's capital if the payments are designed to liquidate all or part of the partner's interest in property contributed to the partnership rather than to provide the partner with a return on an investment in the partnership. Under § 1.707-4(a)(1)(ii), a transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital, is determined without regard to the partnership's income, and is reasonable (within the meaning of § 1.707-4(a)(3)) is presumed to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is part of a sale.

Section 1.707-4(a)(3)(i) provides that a guaranteed payment for capital is reasonable if the transfer is made pursuant to a written provision of a partnership agreement that provides for the payment for the use of capital in a reasonable amount, and only to the extent that the payment is made for the use of capital after the date on which that provision is added to the partnership agreement.

Section 1.707-4(a)(3)(ii) provides that a guaranteed payment is reasonable in amount if the sum of any guaranteed payment for capital that is payable for that year does not exceed the amount determined by multiplying either the partner's unreturned capital at the beginning of the year or, at the partner's option, the partner's weighted average capital balance for the year by the safe harbor interest rate for that year. The safe harbor interest rate equals 150 percent of the highest applicable Federal rate, at the appropriate periods, in effect at the time the guaranteed payment is first established pursuant to a binding written agreement.

Section 1.707-4(b)(1) provides the presumption that an operating cash flow distribution is not part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is part of the sale.

Section 1.707-4(b)(2)(i) states that one or more transfers of money by the partnership to a partner during a taxable year of the partnership are operating cash flow distributions for purposes of paragraph (b)(1) of this section to the extent that those transfers are not presumed to be guaranteed payments for capital under paragraph (a)(1)(ii) of this section, are not reasonable preferred returns within the meaning of paragraph (a)(3) of this section, are not characterized by the parties as distributions to the partner acting in a capacity other than as a partner, and to the extent they do not exceed the product of the net cash flow of the partnership from operations for the year multiplied by the lesser of the partner's percentage interest in overall partnership profits

for that year or the partner's percentage interest in overall partnership profits for the life of the partnership. For purposes of the preceding sentence, the net cash flow of the partnership from operations for a taxable year is an amount equal to the taxable income or loss of the partnership arising in the ordinary course of the partnership's business and investment activities, increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income and decreased by; (A) Principal payments made on any partnership indebtedness; (B) Property replacement or contingency reserves actually established by the partnership; (C) Capital expenditures when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow; and, (D) Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.

Section 1.707-4(b)(2)(ii) provides an operating cash flow safe harbor. That safe harbor states that for any taxable year, in determining a partner's operating cash flow distributions for the year, the partner may use the partner's smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year.

Section 1.707-5(a) states that for the purposes of 1.707-3, 1.707-4, and 1.707-5, if a partnership assumes or takes property subject to a qualified liability of a partner, the partnership is treated as transferring consideration to the partner only to the extent that the transfer of property to the partnership is otherwise treated as part of a sale.

Section 1.707-5(a)(6)(i)(A) provides that a liability assumed or taken subject to by a partnership in connection with a transfer of property to the partnership by a partner is a qualified liability of the partner to the extent the liability was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period.

CONCLUSIONS

We conclude that the guaranteed payments to be made by PRS2 to PRS constitute reasonable guaranteed payments for capital within the meaning of § 1.707-4(a) provided that the payments will be recalculated should PRS's unreturned capital amount change. We also conclude that the debt encumbering the Property is a qualified liability under § 1.707-5. Because there are no facts indicating that the guaranteed payments or cash flow distributions to be made to PRS are part of a sale, the guaranteed payments and the cash flow distributions are presumed not to be part of a sale. Accordingly, the transfer of the Property by PRS to PRS2, subject to the qualified liability, will not be treated as part of a sale under § 707(a)(2)(B).

Except as specifically ruled on above, no opinion is expressed or implied regarding the consequences of this transaction under any other provision of the Code. In particular, no opinion is expressed concerning the treatment of partnership liabilities under § 752.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Signed/Daniel J. Coburn
DANIEL J. COBURN
Assistant to the Branch Chief, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs & Special Industries)

Enclosures: 2
Copy of this letter
Copy of for sec. 6110 purposes