Private Letter Ruling 8651050, IRC Section 47

Reference(s): Code Sec. 47;
Code Sec. 47

September 22, 1986

This is in response to a letter dated July 12, 1985, and subsequent correspondence dated October 3, 1985 and May 14, 1986, that were submitted by your authorized representative. The letters request rulings concerning the federal income agreements and changes in the allocations to the partners in those agreements. The facts of that transaction as represented in the letters are substantially as set forth below.

Corp X is a corporation that was organized under the laws of State B on a for the purpose of engaging in the Business. Corp X acts as the sole general partner for two limited partnerships, Ltd. P-1 and Ltd. P-2, and in that capacity manages the operations of the equipment owned by Ltd. P-1 and Ltd. P-2. Corp X's principal office is located in City C.

Ltd. P-1 was formed as a State B limited partnership on b. Allocations of income, gain, loss, deduction, credit and cash distributions are currently allocated . . . percent to Corp X, as general partner, and . . . percent to the limited partners of Ltd. P-1, as a group, until the “conversion date” (payout). On payout, the allocations shift, subject to certain penalty provisions, to . . . percent to Corp X, as general partner, and . . . percent to the limited partners, as a group. To date, payout has not occurred for Ltd. P-1. Most of the limited partners of Ltd. P-1 are individual taxpayers.

The sole business of Ltd. P-1 is the ownership and operation of the Equipment I. the Equipment I was placed in service on . . . . Investment credits in the amount of approximately . . . attributable to the Equipment I, was claimed by Ltd. P-1, and allocated among the partners, in accordance with the ratio in which the partners divided the general profits of the limited partnership, for Ltd P-1's . . . tax years, respectively. The Equipment I is currently operating in the . . . U.S. . . .
under . . . contracts with various . . . companies.

By letter dated . . . the Service issued a ruling to the effect that, among other things, (1) the investment tax credit would be shared among the partners of Ltd. P-1 on the basis of the sharing ratios in existence prior to payout, and (2) the shift in the partners' interest at payout would not cause any recapture of previously claimed credits. As of . . . Ltd. P-1 had total assets of approximately . . . total liabilities of approximately . . . and total equity of approximately . . . accounted for on an accrual basis in accordance with generally accepted accounting principles.
Financing for the Equipment I has been obtained through the Maritime Administration's (MARAD) Title XI Program with an outstanding principal balance as of . . . . In addition, financing has been provided by a third party bank through a subordinated note payable, guaranteed by the general partner, which, as of . . . . . was in the amount of . . . . All debt

instruments are recourse to the limited partnership and to the general partner, and the Partnership Agreement provides
that the limited partners need not contribute further capital to Ltd. P-1.

The principal office of Ltd. P-1 is in City C. Ltd. P-1 is subject to the examination jurisdiction of the District Director in City
C and has a tax year ending . . . .

Ltd. P-2 was formed as a State B limited partnership on . . . . Allocations of income, gain, loss, deduction, credit and cash
distributions are currently allocated . . . percent to Corp X, as general partner, and . . . percent to the limited partners of
Ltd. P-2, as a group, until “conversion date” (payout), at which time such allocation shifts to . . . percent to Corp X, as
general partner, and . . . percent to the limited partners, as a group. To date, payout has not occurred for Ltd. P-2. Most of the limited partners of Ltd. P-2 are individual taxpayers.

The sole business of Ltd. P-2 is the ownership and operation of the Equipment II. The first Equipment II item was placed in service on . . . and the second Equipment II item was placed in service on . . . . Investment credits in the amounts of . . . attributable to the first Equipment II item, was claimed by Ltd. P-2 and allocated among the partners, in accordance with the ratio in which the partners divided general profits of the limited partnership, for Ltd. P-2's . . . tax years, respectively. Additionally, investment credits in the amount of approximately . . . attributable to the second Equipment II item was claimed by Ltd. P-2, and allocated among the partnership, in accordance with the ratio in which the partners divided the general profits of the limited partnership, for Ltd. P-2's . . . tax year. The Equipment II items are operating in the . . . . . U.S. . . . under . . . contracts with various . . . companies.

By letter dated . . . the Service issued a ruling to the effect that, among other things, (1) the investment tax credit would be shared among the partners of Ltd. P-2 on the basis of the sharing ratios in existence prior to payout, and (2) the shift in the limited partners' interest at payout would not cause any recapture of previously claimed credits.

As of . . . Ltd. P-2 had total assets of approximately . . . total liabilities of approximately . . . and total equity of approximately . . . accounted for on an accrual basis in accordance with generally accepted accounting principles. Financing for the Equipment II has been obtained through a group of commercial banks. Such debt (of approximately . . . as of . is secured by a first preferred . . . mortgage on the Equipment II and related equipment and all proceeds arising from the Business. Such debt instruments represent recourse debt to the limited partnership and to the general partner. The Partnership Agreement provides that the limited partners need not contribute further capital to Ltd. P-2.

The principal office of Ltd. P-2 is in City C. Ltd. P-2 is subject to the examination jurisdiction of the District Director in City C and has a tax year ending . . . .

Corp X proposes to amend the Partnership Agreements of Ltd. P-1 and Ltd. P-2 by adding a new Section 9.8 to Article IX of each Partnership Agreement, effective as of . . . to read in its entirety as follows:

Section 9.8. If at any time after . . . the allocation of any deduction or loss to a Limited Partner under any other Section of this Article IX would cause the balance in its capital account to be less than zero, only the portion thereof that reduces the balance in its capital account to zero shall be allocated to the Limited Partner and the balance shall be allocated to the General Partner. In the event that an allocation of deductions or losses is made to the General Partner pursuant to this Section 9.8, any income or gain (other than income or gain subject to the provisions of Section 9.3 hereof) realized by the Partnership, from and after the earlier of (i) the Ruling Date or (ii) . . . in the case of Ltd. P-2), that would otherwise be allocated to the Limited Partner shall instead be allocated to the General Partner until the amount of such income or gain so allocated equals the aggregate amount of deductions or losses theretofore allocated to the General Partner under this Section 9.8. For purposes of this Section 9.8, the Ruling Date shall mean . . . (or such later date prior to . . . in the case of Ltd. P-2)., as may be permitted by the Internal Revenue Service) if (and only if) a ruling is issued by the Internal Revenue Service to the Partnership to the effect that the income or gain allocation provisions of this Section 9.8 may become effective prior to . . . . . in the case of Ltd P-2), without resulting in the recapture of investment tax credits theretofore claimed by any Limited Partner.

The ruling referred to in the proposed Section 9.8 that the income or gain allocation provisions may become effective prior to . . . in the case of Ltd. P-1, and . . . . . in the case of Ltd. P-2, without resulting in the recapture of investment credits previously claimed by the limited partners will not be requested from the Service. The “Ruling Date” referred to in the proposed Section 9.8 will, therefore, not occur and the special allocation of income provision will not become effective until . . . in the case of Ltd. P-1, and . . . in the case of Ltd. P-2. Furthermore, no ruling is being requested concerning whether the special allocation of income provision under the proposed Section 9.8 will result in the recapture of previously claimed investment credits by any partner after the effective date of such provisions, . . . in the case of Ltd. P-1, and . . . in the case of Ltd. P-2.

Section 9.3 of Article IX of the Partnership Agreements referred to in proposed Section 9.8 provides as follows:

Section 9.3. Notwithstanding the foregoing, Partnership gain from the sale, exchange, abandonment, foreclosure or other disposition (other than by lease) of all or a portion of the Partnership property or any interest therein or from any other capital transaction or event covered by Section 8.4 above during any fiscal year or years of the Partnership shall be allocated among the Partners, as follows:

(a) First, such gain shall be allocated to the extent, and in same ratio that the proceeds arising from such sale or other
capital event are distributed pursuant to subsection 8.4(c)(1) above.

(b) Second, gain (if any) in excess of the gain allocated pursuant to subsection 9.3(a) above shall be allocated to each Partner to the extent that the total of (i) the aggregate cash distributed to such Partner over the term of the Partnership pursuant to Sections 8.2 and 8.4 above plus (ii) the aggregate expenses and losses allocated to such Partner over the term of the Partnership under this Article IX, exceeds the total of (i) the aggregate Capital Contributions to the Partnership by such Partner plus (ii) the aggregate income and gain allocated to such Partner over the term of the Partnership under this Article IX.

(c) Third, gain (if any) in excess of the gain allocated pursuant to subsections 9.3(a) and (b) above shall be allocated to the General Partner, or to the Limited Partners, or both, in the aggregate, as the case may be, in such amounts as will result in the ratio between (i) the aggregate balance in the Limited Partners' capital accounts and (ii) the balance in the General Partner's capital accounts being equal to the ratio between their respective Post-Conversion Sharing Ratios.

(d) Any gain not allocated pursuant to the foregoing subsections 9.3(a), (b) and (c) shall be allocated among the Partners in accordance with their respective Post-Conversion Sharing Ratios.

Section 9.3, in general, provides for the allocation of gains from the disposition of all or part of the limited partnership property. Subsections 9.3(a) and 8.4(c)(1) requires that to the extent the conditions necessary to cause the partners' interests to shift to post-conversion sharing ratios have not occurred at the time of the disposition, proceeds therefrom will be distributed to the partners in an amount necessary to cause such shift to occur, and a corresponding amount of
the gain will be allocated to them. Subsections 9.3(b) and (c) provide that any additional gain will be allocated to first bring any negative capital account to zero, and then the excess gain will be allocated with the result that the ratio of all capital accounts will equal the post-conversion sharing ratio. Corp X represents that this section does not alter the allocation of the general profits under Section 708(a)(8) of the Internal Revenue Code.

Corp X further represents that no other provisions of the Partnership Agreements will be changed or altered. The Partnership Agreements provide, in part, that: (1) the allocation of income and deductions and cash distributions are reflected in each partner's capital account; (2) the partners' capital accounts are maintained in accordance with all provisions of the Internal Revenue Code; (3) liquidation proceeds are, throughout the term of the limited partnerships, distributed in accordance with the capital account balances of each partner; and (4) if the general partner has a negative balance in its capital account upon liquidation of the limited partnerships, the general partner shall under specific circumstances contribute capital to the limited partnerships.

The purpose of the proposed amendments is to conform the Partnership Agreements with section 1.704-1(b) of the Income Tax Regulations. As a result of the current depressed market for the equipment owned by the limited partnerships, Ltd. P-1 and Ltd. P-2 have incurred net losses for purposes of federal income taxes. The limited partners' allocable portion of such losses is in excess of their positive capital account balances. Therefore, according to Corp X, EXAMPLE (15) of section 1.704-1(b)(5) of the regulations requires that such losses should not be allocated to the limited partners, but should be reallocated to the general partner, the partner that bears the risk of loss.

In addition, in order to have "substantial economic effect," under section 1.704-1(b)92)(ii) of the regulations, allocations must reflect the "underlying economic arrangement of the partners." Consequently, in order to maintain the original economic arrangement agreed to in the Partnership Agreements, an equal amount of subsequent income will be reallocated to the general partner before allocating in accordance with the originally agreed to profit ratios. Thus, in accordance with EXAMPLE (1)(VII) of section 1.704-1(b)(5) of the regulations, such reallocation of income has substantial economic effect. Corp X represents that the allocations and reallocations of income, gains, losses, deduction and credits have "substantial economic effect" and no ruling is being requested with regard to this matter.

Section 38 of the Internal Revenue Code provides for a general business credit that includes for a taxable year the investment credit determined under section 46(a). Sections 46(a) and (c) provide that the amount of the investment credit for any taxable year is equal to the sum of certain specified percentages of the qualified investment in section 38 property.

Section 47(a)(1) of the Code and section 1.47-1(a)(1)(i) of the Income Tax Regulations provide that if during any taxable year any property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the useful life that was taken into account in computing the credit under section 38, then the tax under chapter 1 for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits
allowed under section 38 for all prior taxable years that would have resulted solely from substituting, in determining qualified investment, for such useful life the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceases to be section 38 property. Section 47(a)(5) provides a similar rule with respect to section 38 recovery property.

Section 1.46-3(f)(1) of the regulations provides, in part, that in the case of a partnership, each partner shall take into account separately, for his or her taxble year with or within which the partnership taxable year ends, his or her share of the basis of partnership new section 38 property placed in service by the partnership during such partnership taxable year.

Section 1.46-3(f)(2)(i) of the regulations provides, in part, that each partners' share of the basis (or cost) of any section 38 property shall be determined in accordance with the ratio

in which the partners divide the general profits of the partnership (that is, the taxable income of the partnership as described in section 702(a)(8) of the Code (formerly section 702(a)(9) prior to is redesignation by section 1901(b)(1)(I) of the Tax Reform Act of 1976)) regardless of whether
the partnership has a profit or a loss for its taxable year ending during which the section 38 property is placed in service.

Section 1.47-6(a)(2)(i) of the regulations provides, in part, that if - (a) the basis (or cost) of partnership section 38 property is taken into account by a partner in computing his or her qualified investment, and (b) after the date on which such partnership section 38 property was placed in service by the partnership and before the close of the estimated useful life of the property, such partner's proportionate interest in the general profits of the partnership (or in the particular item of property) is reduced (for example, by a sale, by a change in the partnership agreement, or by the admission of a new partner) below the percentage specified in subdivision (ii) of this subparagraph, then, on the date of such reduction such partnership section 38 property ceases to be section 38 property with respect to such partner to extent of the actual reduction in such partner's proportionate interest in the general profits of the partnership (or in the particular item of property). Accordingly, a recapture determination shall be made with respect to such partner.

Section 1.47-6(a)(2)(ii) of the regulations provides, in part, that the percentage referred to in subdivision (i)(b) of this subparagraph is 66 2/3 percent of the partner's proportionate interest in the general profits of the partnership (or in the particular item of property) for the year in which such property was placed in service.

Section 702(a)(8) of the Code provides that in determining his or her income tax, each partner shall take into account separately his or her distributive share of the partnership's taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection. Among other items requiring separate computation under other paragraphs of subsection 702(a) are items of income, gain, loss, deduction or credit that are required to be separately taken into account by regulations prescribed by the Secretary. Section 702(a)(7).

Section 1.702-1(a)(8)(i) of the regulations provides, in part, that each partner shall take into account separately, as part of any class of income, gain, or loss, deduction, or credit, his or her distributive share of any items of income, gain, loss, deduction, or credit subject to a special allocation under the partnership agreement that differs from the allocation of partnership taxable income or loss generally.

Section 704(b) of the Code provides that a partner's distributive share of income, gain, loss, deduction or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances) if - (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Section 1.704-1(b)(1)(i) of the regulataions provides, in part, that if a partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner but such allocation does not have substantial economic effect, then the partner's distributive share of such income, gain, loss, deduction or credit (or item thereof) shall be determined in accordance with such partner's interest in the partnership (taking into account all facts and circumstances). If the partnership agreement provides for the allocation of income, gain loss, deduction, or credit (or item thereof) to a partner, there are three ways in which such allocation will be respected under section 704(b) and this paragraph. First, the allocation can have substantial economic effect in accordance with paragraph (b)(2) of this section.
Second, taking into account all facts and circumstances, the allocation can be in accordance with the partner's interest in the partnership. Third, the allocation can be deemed to be in accordance with partner's interest in the partnership pursuant to one of the special rules contained in paragraph (b)(4) of this section.

Given the facts as represented by Corp X, the issue is whether the change in the allocation to the partners of partnership losses and income, pursuant to sections 9.3 and 9.8 of the Partnership Agreements, results in a reduction in the partners' interest in the “general profits” of the limited partnerships, as that term is defined in section 1.46-3(f)(2)(i) of the regulations. If there is a reduction, and that reduction is below the percentage specified in section 1.47-6(a)(2)(ii), namely 66 2/3 percent of the partner's proportionate interest in the general profits of the partnership for the year in which the section 38 property was placed in service, then under section 47(a)(5) of the Code, any previously taken investment credits must be recaptured. If, however, the change in the allocation to the partners does not reduce the “general profits” of the limited partnerships, no recapture occurs.

New section 9.8 of the Partnership Agreements allocates losses and income necessary to comply with section 1.704-1(b) of the regulations. Under section 9.3 of the Partnership Agreements, the limited partners continue to share income and losses in the amount of . . . percent prior to payout and . . . percent thereafter. The temporary allocation pursuant to section 9.8 serves only to restore the original economic profit arrangement, and as such, maintains the requirements for “substantial economic effect.” Therefore, in the aggregate, the allocations of the general profits to the partners has not been reduced.

Section 9.3 of the Partnership Agreements allocates to the partners partnership gains attributable to the disposition of partnership property and other items that in accordance with the regulations, that are attributable to capital not reinvested or otherwise expended in the conduct of the partnership business. This provision of the Partnership Agreements also provides circumstances that will result in a change in the allocation of those gains among the partners. The method of the allocation of the gains under Section 9.3 of the Partnership Agreements is different from the method of allocation provided for in Sections 9.1 and 9.2 for all other items of partnership income, gain, loss, deduction and credit.

For purposes of the investment tax credit provisions, section 1.46-3(f)(2)(i) of the regulations provides that the term “general profits” of a partnership means the taxable income of the partnership as described in section 702(a)(8) of the Code.

Section 702(a) of the Code enumerates eight classes of items of partnership income, gain, loss, deduction and credit, distributive shares of which partners are required to report on their income tax returns. The first six categories, sections 702(a)(1) through 702(a)(6), are specific items, such as capital gains and losses, and gains and losses attributable to the sale of section 1231 property. Section 702(a)(7) deals with other items not enumerated in the first six subsections but that are provided by regulations. The eighth category, as described in section 702(a)(8), is a catch-all or residual provision that includes all taxable income or loss not enumerated under the first seven categories.

Our examination of the Partnership Agreements reveals that the items of gain provided for in Section 9.3 of the Partnership Agreements are items described in section 702(a)(1) through 702(a)(7) of the Code, and, therefore, are not Items described in section 702(a)(8). Accordingly, any change in the allocation of gain pursuant to Section 9.3 of the Partnership Agreements will not result in a reduction of a partner's interest in the general profits of the limited partnerships, as that term is defined in section 1.46-3(f)(2)(i) of the regulations. Therefore, since there is no reduction in a partner's interest in the general profits of the limited partnerships, pursuant to sections 9.3 and 9.8 of the Partnership Agreements, Ltd. P-1's and Ltd. P-2's section 38 property will continue to be section 38 property, with no resulting recapture of previously taken investment credits.

Accordingly, on the basis of the facts as submitted and the application of the applicable federal income tax law, the following is held for federal income tax purposes:

1. That no recapture of investment credits will result to the limited partners of Ltd. P-1 as a result of the reallocation to the general partner of losses, in any taxable year beginning on or after . . . . . otherwise allocable to the limited partners, to the extent such losses exceed the then positive balance of the capital accounts of the limited partners, provided that the allocations of the Partnership Agreement have substantial economic effect.

2. That no recapture of investment credits will result to the limited partners of Ltd. P-2 as a result of the reallocation to The general partner of losses in any taxable year beginning on or after . . . . . otherwise allocable to the limited partners, to the extent, such losses exceed the then positive balances of the capital accounts of the limited partners, provided that the allocations in the Partnership Agreement have substantial economic effect.

3. That the allocation of gain, pursuant to section 9.3 of Article IX of the ltd. P-1 Partnership Agreement, will not be considered a disposition of any partner's interest in the general profits of the partnership, and that no investment credit recapture will result solely from the allocation of any gain from the disposition (other than by lease) of all or a portion of the partnership property, provided that the allocations in the Partnership Agreement have substantial economic effect.

4. That the allocation of gain pursuant to section 9.3 of Article IX of the Ltd. P-2 Partnership Agreement, will not be considered a disposition of any partner's interest in the general profits of the partnership, and that no investment credit recapture will result solely from the allocation of any gain from the disposition (other than by lease) of all or a portion of the partnership property, provided that the allocations in the Partnership Agreement have substantial economic effect.

No opinion is expressed or implied concerning whether the allocations in Ltd. P-1's and Ltd. P-2's Partnership Agreements of the partners' shares of income, gain, loss, deduction and credit are in accordance with the provisions of section 704(b) of the Code and the regulations thereunder. Furthermore, no opinion is expressed or implied as of the federal income tax treatment of the amendments to the Partnership Agreements under other provisions of the Code and regulations.

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

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.