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## **PLR 9426006**

\*\*\* This is in response to your letter dated November 15, 1993, on behalf of N, requesting rulings on the application of sections 108 and 1017 to the transaction described below. The information submitted for consideration is summarized below.

A, B, C, D, and E each hold interests in Limited Partnership 1, a limited partnership organized under the laws of State X, in the amounts of a%, b%, c%, d% and e%, respectively. A, B, D, E, F, G, and H each hold interests in Limited Partnership 2, a limited partnership organized under the laws of State X, in the amounts of f%, g%, h%, i%, j%, k% and l%, respectively. I and J each hold interests in Limited Partnership 3, a limited partnership organized under the laws of State Y, in the amounts of m% and n%, respectively. K, L, M and N each hold interests in Limited Partnership 4, a limited partnership organized under the laws of State X, in the amounts of o%, p%, g% and r%. A, B, C, D, E, F, G, H, I, J, K, L, M and N are collectively referred to as "the Partners." None of the Partners are subchapter C corporations.

Limited Partnership 1, Limited Partnership 2, Limited Partnership 3 and Limited Partnership 4 (collectively the "Upper Tier Partnerships") each hold interests in Partnership in the amounts of s%, t%, u% and v%, respectively. Partnership is the sole-owner of Property, a multi-tenant office building in City. Property is the principal asset of Partnership. Under the leases between Partnership and its tenants, Partnership pays all operating expenses during the lease term, up to an annual base amount, and any electricity charges that are not directly billed to the tenant. Tenants are responsible for any operating expenses over the base amount. It is represented that Partnership will spend approximately w% of its gross income on operating expenses in 1993 and that the leases are not "net leases."

Partnership entered into an agreement with Management to manage the day-to-day operations of Property and to act as the leasing agent for Property during Period 1. In addition to leasing Property, the services which Management performs on behalf of Partnership include: (1) arranging for any necessary repairs; (2) hiring, evaluating and supervising employees and agents needed to operate and maintain Property; (3) purchasing supplies and materials necessary to operate and maintain Property; (4) billing and collecting rent, taxes and insurance from the tenants; (5) cleaning the public areas of Property; (6) obtaining all licenses and permits necessary for the operation of Property; (7) paying all bills received for services, work and supplies, including real estate taxes, insurance premiums and debt service on financing; and (8) preparing and submitting monthly income and expense reports to Partnership.

In Year 1, Partnership borrowed approximately \$x from Bank to purchase and renovate Property. In addition, Partnership borrowed \$y and \$z in Year 2 from Bank. All of the loans were nonrecourse and were secured by mortgages on Property.

On date 1, Partnership filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code (title 11, U.S.C.). At the time that Partnership commenced the bankruptcy, the principal amount of Partnership's indebtedness to Bank was approximately \$aa. As part of Partnership's

plan of reorganization, Partnership's indebtedness to Bank will be restructured. The Partners believe that the restructuring of Partnership's indebtedness to Bank constitutes a modification of debt under section 1001 and that they will realize discharge of indebtedness income as a result of the restructuring.

Under section 61(a)(12) of the Code, gross income includes income from the discharge of indebtedness. See also section 1.61-12(a) of the Income Tax Regulations.

Section 108 of the Code excludes discharge of indebtedness income from gross income under certain circumstances. Section 108(a)(1)(D) excludes discharge of indebtedness income from a taxpayer's gross income if, in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness. Section 108(c) provides special rules for the exclusion of discharge of indebtedness income under section 108(a)(1)(D).

As an initial matter, we note that the exception set forth in section 108(a)(1)(A) for discharges in bankruptcy will not apply to exclude any discharge of indebtedness income resulting from the restructuring of Partnership's indebtedness to Bank. Section 108(d)(6) provides, in part, that subsection (a) shall be applied at the partner level. Because Partnership, rather than the Partners, is in bankruptcy, the exception set forth in section 108(a)(1)(A) does not apply to exclude discharge of indebtedness income from the Partners' gross income. Therefore, section 108(a)(2)(A), which provides, in part, that the exception provided for in section 108(a)(1)(D) shall not apply to a discharge that occurs in bankruptcy, does not prevent the application of section 108(a)(1)(D) to the Partners.

Section 108(c)(3) defines "qualified real property business indebtedness" as indebtedness which (A) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property, (B) was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness, and (C) with respect to which the taxpayer makes an election to have this paragraph apply.

The legislative history underlying section 108(a)(1)(D) provides that in the case of discharge of indebtedness of a partnership, the determination of whether debt is qualified real property business indebtedness is made at the partnership level. For example, if partnership debt is discharged, the determination of whether debt was incurred or assumed in connection with real property used in a trade or business is made by reference to the trade or business of the partnership and real property owned by the partnership. The election to apply the provision is made at the partner level, however, on a partner by partner basis. H.R. Rep. No. 111, 103rd Cong., 1st Sess., at 622-25 (1993). Therefore, the determination of whether Partnership's indebtedness to Bank was incurred or assumed in connection with real property used in a trade or business will be made by reference to the ownership and rental of Property by Partnership. The election to apply section 108(a)(1)(D) must be made by the Partners, on a partner by partner basis.

The rental of even a single property may constitute a trade or business under various Internal Revenue Code provisions. See, e.g., *Hazard v. Commissioner*, 7 T.C. 372 (1946), acq. 1946-2 C.B. 3 (section 117 of the 1939 Code); *Post v. Commissioner*, 26 T.C. 1055 (1956), acq. 1958-2 C.B. 7 (same); *Fegan v. Commissioner*, 71 T.C. 791 (1979), aff'd 81-1 USTC para. 9436 (10th Cir. 1981) (section 1231); *Curphey v. Commissioner*, 73 T.C. 766 (1980) (section 280A); *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940) (section 871). However, the ownership and rental of real property does not, as a matter of law, constitute a trade or business. *Curphey*, 73 T.C. at 766. The issue is ultimately one of fact in which the scope of a taxpayer's activities,

either personally or through agents, in connection with the property, are so extensive as to rise to the stature of a trade or business. *Bauer v. Commissioner*, 168 F. Supp. 539, 541 (Ct. Cl. 1958).

In *Rev. Rul. 73-522*, 1973-2 C.B. 226, the Service held that rental of real property under a "net lease" does not render the lessor engaged in a trade or business with respect to such property for purposes of section 871 of the Code. Section 871 provides special rules for taxation of a nonresident alien engaged in a trade or business in the United States. Under the facts of the ruling, the taxpayer owned rental property situated in the United States that was subject to long-term leases providing for monthly payments by the lessee of real estate taxes, operating expenses, ground rent, repairs, interest and principal on existing mortgages, and insurance in connection with the leases property.

Section 108(c)(1)(a) provides that the amount excluded from gross income under subparagraph (D) of subsection (a)(1) is applied to reduce the basis of the depreciable real property of the taxpayer. Section 108(c)(1)(B) cross-references section 1017 for the applicable provisions for making the basis reduction described in section 108(c)(1)(A).

Section 1017(a) provides the general rule that if (1) an amount is excluded from gross income under section 108(a), and (2) under section (b)(2)(D), (b)(5), or (c)(1) of section 108, any portion of that amount is to be applied to reduce basis, then that portion is applied in reduction of basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which discharge occurs.

Section 1017(B)(1) provides the general rule that the amount of reduction to be applied under subsection (a) (not in excess of the portion referred to in subsection (a)), and the particular properties the bases of which are to be reduced, is determined under regulations prescribed by the Secretary.

Notwithstanding the general rule of section 1017(b)(1), section 1017(b)(3) provides that certain reductions may only be made in the basis of depreciable property. Section 1017(b)(3)(A) provides that any amount which under section 108(b)(5) or is to be applied to reduce basis is applied only to reduce the basis of depreciable real property held by the taxpayer.

Section 1017(b)(3)(C) provides that, for purposes of this section, any interest of a partner in a partnership is treated as depreciable property to the extent of such partner's proportionate interest in the depreciable property held by the partnership. The preceding sentence applies only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to the partner.

*Rev. Rul. 87-115*, 1987-2 C.B. 163, provides that, under section 743(b) of the Code, the sale of an interest in an upper tier partnership results in an adjustment to the basis of the property of the lower tier partnership in which the upper tier partnership has an interest if, and only if, both the upper tier partnership and the lower tier partnership have made an election under section 754.

Based solely on the information submitted and provided that the leases between Partnership and its tenants constitute valid leases for federal income tax purposes, we rule as follows:

(1) Property is real property used in a trade or business within the meaning of section 108(c)(3)(A). Therefore, provided a timely election is made by the Partners, on a partner by partner basis, to have section 108(c) apply, Partnership's indebtedness to Bank constitutes qualified real property business indebtedness as defined in section 108(c)(3) with respect to an electing Partner.

(2) Provided that the restructuring of Partnership's indebtedness to Bank results in discharge of indebtedness income and to the extent the electing partner is not insolvent within the meaning of section 108(d)(3) (see 108(a)(2)(B)), any discharge of indebtedness income resulting from such restructuring will be excluded from an electing Partner's gross income under section 108(a)(1)(D), subject to the limitations provided in section 108(c)(2)(A) and (B).

(3) For purposes of section 1017(b)(3)(C), the Upper Tier Partnership's interest in Partnership is treated as depreciable property to the extent of the Upper Tier Partnership's proportionate interest in the depreciable property held by Partnership, provided there is a corresponding reduction in Partnership's basis in depreciable property with respect to the Upper Tier Partnership. Similarly, the Partners' interests in the Upper Tier Partnership is treated as depreciable property to the extent of the Partners' proportionate interest in the depreciable property held by the Upper Tier Partnership, provided that there is a corresponding basis reduction in the Upper Tier Partnership's basis in depreciable property with respect to the Partners. Cf. Rev. Rul. 87-115, 1987-2 C.B. 163 (section 754 elections required at both upper and lower tiers).

No opinion is expressed about the federal income tax treatment of the transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by this ruling. Specifically, no opinion is expressed, and none was requested, as to whether, and to what extent, the restructuring of Partnership's indebtedness to Bank results in discharge of indebtedness income under section 61(a)(12). In addition, no opinion is expressed, and none was requested, about the application of section 1001 to the restructuring of Partnership's indebtedness to Bank. Further, except as specifically set forth in this ruling, no opinion is expressed, and none was requested, about the application of any other provision of section 108 to the taxpayers or to Partnership's indebtedness to Bank.

This office has not made any determination about the characterization of the leases between Partnership and its tenants for federal income tax purposes. If the Service, upon audit, subsequently determines that the leases between Partnership and its tenants are not true leases for federal income tax purposes, then all the rulings are void.

The above rulings are directed only to the taxpayers who requested them. Section 6110(j)(3) of the Code provides that these rulings may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this letter are consummated.

In accordance with the power of attorney on file in this office, a copy of this letter is being sent to the taxpayer.

Sincerely yours,  
Assistant Chief Counsel (Income  
Tax & Accounting)  
By: Amy J. Sargent  
Assistant to the Branch Chief,  
Branch 3  
basis, discharged indebtedness partnerships

